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Contracts as Literature: A Hermeneutic Approach to the Implied Duty of Good Faith and Fair Dealing in Commercial Loan Agreements

Barbara A. Fure*

INTRODUCTION

Banks have been receiving bad press lately. They have been compared to black widow spiders¹ (the females eat their mates shortly after mating). They have been described as "crude," "malicious," "insensitive," and "at best, cavalier."² Apparently, based on the large number of lender liability lawsuits, many borrowers strongly agree with these statements. In the decade of the 1980's there was an explosion of lender liability lawsuits in which borrowers sued their lenders, many claiming that the lender breached the duty of good faith and fair dealing implied in every contract.³ This explosion continues to have reverberations into the decade of the 1990's.⁴ In the past, the majority of courts that have been

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1. "Shortly after mating, the black widow spider eats her mate. Sadly, many business banking relationships don't last much longer." Wall St J at A7 (June 4, 1991) (as stated in an advertisement for Continental Bank).

2. *Tolander v Farmers National Bank*, 452 NW2d 422, 425-26 (Iowa 1990). In *Tolander*, a strapped farmer's operation was closed out by a bank's setting off without notice an unpaid loan from the farmer's checking account. *Tolander*, 542 NW2d at 422-23.

3. See, for example, *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*, 908 F2d 1351 (7th Cir 1990); *Penthouse Int'l., Ltd. v Dominion Fed. Sav. & Loan Ass'n*, 855 F2d 963 (2d Cir 1988); *Reid v Key Bank of S. Me., Inc.*, 821 F2d 9 (1st Cir 1987); *K.M.C. Co., Inc. v Irving Trust Co.*, 757 F2d 752 (6th Cir 1985); *Watseka First Nat'l Bank v Ruda*, 135 Ill 2d 140, 552 NE2d 775 (1990); *First Security Bank of Idaho v Gaige*, 115 Idaho 172, 765 P2d 683 (1988); *Rigby Corp. v Boatmen's Bank and Trust Co.*, 713 SW2d 517 (Mo Ct App 1986); *Centerre Bank of Kansas City v Distributors, Inc.*, 705 SW2d 42 (Mo Ct App 1985).

4. See, for example, *Fasolino Foods Co., Inc. v Banca Nazionale Del Lavoro*, 961 F2d 1052 (2d Cir 1992); *Mirax Chem. Prod. Corp. v First Interstate Commercial Corp.*, 950 F2d 566 (8th Cir 1991); *Bohm v Commerce Union Bank of Tenn.*, 1992 WL 135130 (WD Pa 1992); *Temp-Way Corp. v Continental Bank*, 139 Bankr 299 (ED Pa 1992); *Whorley v First Westside Bank*, 240 Neb 975, 485 NW2d 578 (1992) *Diversified Foods Inc. v First Nat'l Bank of Boston*, 605 A2d 609 (Me 1992); *State Bank of Standish v Curry*, 190 Mich App 616, 476 NW2d 635 (1991); *Components Direct, Inc. v European Am. Bank and Trust Co.*,

presented with this claim have rejected it for various reasons.⁵ Recently, however, cases indicate and some experts believe that the "pendulum" is swinging toward borrowers.⁶ Nevertheless, all would probably agree that the injection of the doctrine of the implied duty of good faith into commercial loan agreements has produced a confusing array of cases and commentary.

The doctrine of the implied duty of good faith and fair dealing permeates cases resolving disputes over a bank's or other financial lending institution's duties to its borrower in a commercial loan setting. While the doctrine has struck fear into the hearts of many a lender and its counsel, and has brought solace to a few finan-

175 AD2d 227, 572 NYS2d 359 (1991); *Seattle First Nat'l Bank v Westwood Lumber, Inc.*, 65 Wash App 811, 829 P2d 1152 (1992). See also Joseph S. Hellman, *Arbitration Clause Can Stave Off Legal Wars*, *Am Banker* at 4 (Feb. 4, 1992) ("The financial climate has renewed the threat of lender liability.").

5. See, for example, *Mirax Chem. Prod. Corp. v Interstate Commercial Corp.*, 950 F2d 566 (8th Cir 1991)(the implied duty of good faith does not apply to demand instruments); *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*, 908 F2d 1351 (7th Cir 1990)(the implied duty of good faith does not overrule literal enforcement of express terms in agreement); *Spencer Companies, Inc. v Chase Manhattan Bank*, 81 Bankr 194 (D Mass 1987)(the holder of a demand does not need a good faith reason or any reason at all to demand payment); *Flagship Nat'l Bank v Gray Distribution System, Inc.*, 485 S2d 1336 (Fla Dist Ct App 1986)(good faith does not override express terms in the contract); *First Sec. Bank of Idaho v Gaige*, 115 Idaho 172, 765 P2d 683 (1988)(bank did not breach implied duty of good faith when it exercised its express rights in the written agreement); *Watseka First Nat'l Bank v Ruda*, 135 Ill 2d 140, 552 NE2d 775 (1990)(the test for whether lender accelerated loan in good faith is subjective/honest belief standard; here lender had honest belief that obligation could not be paid). Compare *Reid*, 821 F2d at 9 (cited in note 3)(evidence concerning manner in which bank conducted dealings with commercial borrower, in precipitously and without warning halting further advances on which it knew borrower's business depended, supported jury verdict of bad faith); *K.M.C.*, 757 F2d at 752 (cited in note 3)(lender's power to demand repayment under a demand note was subject to good faith obligation); and *Weinberg v Farmers State Bank of Worden*, 231 Mont 10, 752 P2d 719 (1988) (bank breached implied duty of good faith by failing to extend line of credit in accordance with agreement with debtor).

6. *Experts Say Pendulum Swinging Toward Borrowers in Lender Liability*, BNA Banking Report at 949 (Dec. 9, 1991). See also Hellman, *Am Bankr* at 4 (cited in note 4), stating that "Worse still, the intermediate appellate courts in New York, at least now, seem to be buying some of these arguments. Bad law is being made. Lenders are not only not collecting on simple promissory notes; they are incurring possible affirmative liability to their borrowers." See also *Quality Automotive Co. v Signet Bank/Maryland*, 775 F Supp 849 (D Md 1991)(bank has a duty to exercise good faith with regard to notice when deciding to terminate the loan and security agreement); *B.P.G. Autoland Jeep-Eagle v Chrysler Credit*, 785 F Supp 222 (D Mass 1991)(cut-off of borrower's line of credit is act of bad faith); *Components Direct v European American Bank*, 175 AD2d 227, 572 NYS2d 359 (1991)(bank could be found to have violated good faith when it terminated credit to corporation without notice); and *Siegner v Interstate Prod. Credit Ass'n*, 109 Or App 417, 820 P2d 20 (1991)(evidence of breach of oral agreement supported breach of implied duty of good faith).

cially-ruined borrowers, it has nevertheless engendered nothing but confusion and, at times, injustice. This article is a response to that confusion. The article will show that, as currently applied to commercial loan agreements, the doctrine is unnecessary. The emphasis in resolving the dispute should be on the real issue which, as will be demonstrated, is interpretation. Furthermore, courts resolving these disputes must not only focus on the real issue of interpretation, but they must also begin to apply a more capacious approach to interpretation. They must consider more than the four corners of the written document to determine the agreement between the parties. In the area of loan agreements, courts generally resist looking beyond the written document for meaning. Nevertheless, in many loan transactions, the parties define a significant number of crucial terms in their oral communications prior to or after signing the agreement. Courts must begin to accept this reality and adjudicate cases in a fair manner that reflects this commercial reality.

One possible reason for a court's resistance to looking beyond the written document is suggested by Professor John Murray. Professor Murray has observed that in situations with which a court does not have familiarity, a court's analysis will be limited to the only thing it knows for certain, namely, the documents. Conversely, he observed that the documents will not be conclusive to a court in situations with which it has familiarity.⁷ Thus, in order for a court to determine the nature of the agreement, it must become familiar with the behavior patterns of the parties under the particular circumstances of their transactions. To this end, this article will also attempt to familiarize decisionmakers with the realities of commercial lending so that these decisionmakers understand that the parties usually do not treat the documents as conclusive and, in fact, may totally discount them.

Finally, drawing on the field of literature, this article will introduce readers to and apply the hermeneutics of the literary theorist, E.D. Hirsch.⁸ Hirsch argues that the only valid form of interpretation that is worthy of intellectual respectability is one that considers all of the circumstances surrounding the text.⁹ In the case of commercial loan agreements, the text is the written agreement between the parties.

7. John E. Murray, Jr., *The Realism of Behaviorism Under the Uniform Commercial Code*, 51 Or L Rev 269, 292 (1972).

8. E.D. Hirsch, Jr., *Validity in Interpretation* (1967).

9. See generally Hirsch, *Validity in Interpretation* at 164-207.

Hirsch's theory of interpretation of texts, which is mainly directed to literature, emphasizes the need to discover authorial intent.¹⁰ Therefore, it should not be surprising that his ideas on interpretation are strikingly similar to those of one of the most eminent scholars of contract law, Arthur Corbin, who believes that the aim of contract interpretation should be discovery of the intent of the parties.¹¹ Thus, this article relies heavily on both Hirsch and Corbin in the sections on interpretation since one of the main premises in the article is that courts must focus on the intent of the parties to ensure just results. Furthermore, although Hirsch's theories mirror Corbin's in many ways, Hirsch's theory goes beyond Corbin's. Hirsch, as a literary hermeneutist, provides more insight into the nature of interpretation and more guidance into the process of interpretation, which is, the process of determining and weighing all of the relevant evidence surrounding the text being interpreted.

Looking to the field of literature for interpretive theories to aid in the field of legal interpretation is not new. Usually, however, the theory is being applied to the interpretation of statutes, the Constitution, or judicial opinions.¹² Nevertheless, whether the subject of interpretation is a constitution, "a statute, the words in a con-

10. It should be noted that when interpreting literature, which is the type of text to which Hirsch's theories are mainly directed, the author who is being interpreted is obvious. It is always the writer of the literature. When interpreting contracts, the author is not quite so obvious. Conceivably, there could be two authors. Both parties could have had input into writing the contract. The interpreter would then be the judge. Alternatively, and more likely when dealing with bank loan agreements, there is one author of the contract - the bank. In this case, the borrower, as well as the court, would be an interpreter. This distinction, however, is not a significant distinction for purposes of this article.

In contrast to Hirsch's position is that of Hans-George Gadamer whose theories are frequently the basis of theories of legal interpretation. Gadamer believes that the meaning of a text, not occasionally, but always, goes well beyond its author. H. G. Gadamer, *Truth and Method* 264 (1975). For a discussion of Gadamer's position see generally Francis J. Mootz, *The Ontological Basis of Legal Hermeneutics: A Proposed Model of Inquiry Based on the Work of Gadamer, Habermas, and Ricoeur*, 68 BU L Rev 523, 533 (1988); Teresa G. Phelps and Jenny A. Pitts, *Questioning the Text: The Significance of Phenomenological Hermeneutics for Legal Interpretation*, 29 SLU L Rev 353, 367 (1985).

11. See Arthur L. Corbin, 3 *Corbin on Contracts* Chapters 24 and 26 (West, 1960) ("*Corbin on Contracts*") and Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 Cornell L Q 161 (1965).

12. See, for example, Sanford Levinson, *Law as Literature*, 60 Tex Rev 373 (1982)(constitutional interpretation); Simeon C.R. McIntosh, *Legal Hermeneutics: A Philosophical Critique*, 35 Okla L Rev 1 (1982)(statutory, constitutional, and contract interpretation); Mootz, 68 BU L Rev at 523 (cited in note 10) (statutory, constitutional, and judicial opinion interpretation); Phelps and Pitts, 29 SLU L Rev at 353 (cited in note 10) (constitutional and statutory interpretation); Brad Sherman, *Hermeneutics in Law*, 51 Mod L Rev 386 (1988)(legal interpretation of law in general).

tract, a novel by Henry James, or a poem by Robert Browning,"¹³ the difficulties and opportunities in interpretation are the same.¹⁴

Before undertaking a detailed discussion of Hirsch and his theory, this article will examine the various definitions and applications of the implied duty of good faith within the context of commercial loan agreements. This analysis will show that the underlying issue is determining and interpreting the parties' agreement. Next, the article will review the current law in the area of interpretation of these types of agreements to show that much thinking about meaning and interpretation produces confusion and injustice. In addition, this article will show that current thinking fails to take note of the present day commercial reality of the business of banking. Next, the article will discuss Hirsch's theory of hermeneutics, the interpretation of texts, found in his seminal work on interpretation, *Validity in Interpretation*.¹⁵ Along with this discussion will be a comparison of Hirsch's ideas to those of Professor Corbin. Finally, this article will show that application of Hirsch's principles to contract interpretation in commercial loan settings would be a vast improvement over the current mode of interpreting contracts: by applying Hirsch's principles, courts would recognize current banking practices and, as a result, would enforce the true, intended agreement of the parties based upon their reasonable expectations.

I. THE IMPLIED DUTY OF GOOD FAITH AND FAIR DEALING

There is an overwhelming amount of commentary and case law discussing the implied duty of good faith and fair dealing, its existence, and its meaning.¹⁶ It is now an express obligation in the

13. Corbin, 50 Cornell L Q at 187 (cited in note 11).

14. James B. White, *Law As Language: Reading Law and Reading Literature*, 60 Tex L Rev 415 (1982); see also McIntosh, 35 Okla L Rev at 1 (cited in note 12) ("literary and legal interpretation share some hermeneutic concerns") and Walter B. Michaels, *Against Formalism: The Autonomous Text in Legal and Literary Interpretation*, 1 Poetics Today 23 (1979).

15. See note 8.

16. See, for example, Dennis M. Patterson, *Good Faith and Lender Liability* (Butterworth, 1990); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv L Rev 369 (1980); Susan D. Gresham, "Bad Faith Breach": A New and Growing Concern for Financial Institutions, 42 Vand L Rev 891 (1989); Jane L. Rodda, *The Role of Good Faith in Lender Liability Suits: Rising Star or Fading Gadfly?*, 31 Ariz L Rev 939 (1989); Note, *Illinois Standard of Good Faith Under Section 1-208 of the U.C.C.: Watseka First National Bank v Ruda Creates A Subjective Standard*, 4 DePaul Bus L J 191 (1991); Robert S. Summers, *The General Duty of Good Faith - Its Recognition and Conceptualization*, 67 Cornell L Rev 810 (1982); Comment, *What's So Good About*

Uniform Commercial Code¹⁷ and is acknowledged in the Restatement (Second) of Contracts.¹⁸ Nevertheless, a close examination of the cases and commentary discussing the implied duty of good faith as used in commercial loan documents discloses that application of the concept often causes injustice, and always causes confusion and unpredictability. The reason is that the duty of good faith is really nothing more than the basic contract principle that each party's reasonable expectations should be satisfied according to the agreement, as determined by manifestations of intent. Many courts and commentators already explicitly equate the duty of good faith with a duty to fulfill the justifiable, reasonable expectations of the parties.¹⁹ What the courts are actually deciding, therefore, under the pretext of deciding good faith, is the nature of the parties' expectations as revealed by the circumstances existing when they made their agreement.

A. *The Subjective "Honesty in Fact" Standard*

Frequently, courts define the conduct required by the implied duty of good faith and fair dealing as "honesty in fact."²⁰ This standard has sometimes been referred to as the "pure heart and empty head test."²¹ It requires determining the subjective state of mind of the bank officer. To satisfy this definition of good faith, the bank need only show that its officer had an honest belief that certain conditions were present. This standard is used in situations in which, for example, the bank is claiming that it accelerated payment of a loan under an "insecurity clause" or abruptly terminated a line of credit based on its honest belief that there were valid business reasons for its actions.²² Nevertheless, framing the issue in this manner is inadequate. Instead, the court should determine

Good Faith? The Good Faith Performance Obligation in Commercial Lending, 55 U Chi L Rev 1335 (1988); Comment, Section 1-208: "Good Faith" and the Need for a Uniform Standard, 73 Marq L Rev 639 (1990). See notes 3-5 for cites to cases.

17. Uniform Commercial Code §§ 1-201 and 2-103(1)(b) (1990).

18. Restatement (Second) of Contracts § 205 (1979).

19. See, for example, *Weinberg*, 752 P.2d at 731 (good faith and fair dealing is measured in a particular contract by justifiable expectations of the parties); *State Nat'l Bank v Academia, Inc.*, 802 SW2d 282, 293 (Tex Ct App 1990) (good faith requires exercising discretion in a manner consistent with reasonable expectations); Patterson at notes 83-85 and accompanying text; Burton at notes 61-62 and accompanying text; and Summers at notes 45-49 and accompanying text.

20. See, for example, *Watseka First Nat'l Bank*, 552 NE2d at 778; and *Rigby Corp.*, 713 SW2d at 527.

21. *Watseka First Nat'l Bank*, 552 NE2d at 779.

22. See, for example, *K.M.C.*, 757 F2d at 760.

what the borrower understood the bank to mean when the bank explained how acceleration or termination of credit would be triggered. The fact that a loan officer may have an honest belief that valid business reasons existed to terminate a line of credit is relevant only to the extent that the reasons correspond with what the parties agreed would be a valid reason. Good faith is irrelevant except that it is reflected in keeping one's promises. Furthermore, after the initial question is answered and the court has discovered the act(s) that the parties agreed would trigger an acceleration or termination, the bank must then present objective evidence to show that the act(s) occurred. For example, if impairment of payment was the agreed upon act, the bank would have to rely on objective evidence, such as financial reports showing lack of or decrease in revenue.²³ Thus, it is apparent that the so-called subjective honesty in fact standard is useless in these situations. Moreover, the history of the subjective standard shows that it was never intended to apply to commercial loan transactions. It was intended to apply to the doctrine of good faith purchase of negotiable instruments where, presumably, it is workable.²⁴

B. *K.M.C. Co. Inc. - The Objective Standard*

In contrast to the subjective standard of honesty in fact, several courts have gone much further and have, under the guise of an "objective" standard of good faith, required a duty of reasonableness.²⁵ As a result, obligations have been imposed on banks that were not necessarily part of the parties' intended agreement. For example, in one of the most famous and most frequently criticized "good faith" cases, *K.M.C. Co., Inc. ("K.M.C.") v Irving Trust Company ("Irving")*,²⁶ the Sixth Circuit Court of Appeals held that an instruction to the jury that "there is implied in every contract an obligation of good faith . . . [was] an accurate statement of the applicable law . . ."²⁷ This implied obligation imposed on Irving a duty to give notice to K.M.C. before refusing to advance

23. See James J. White and Robert S. Summers, *Uniform Commercial Code* §25-3 at 1192 (West, 3d ed 1990) quoted in *Watseka First Nat'l*, 552 NE2d at 781.

24. Restatement (Second) of Contracts § 205 Comment b (1979); see also Robert S. Summers, "Good Faith" In *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va L Rev 195, 208 (1968).

25. See, for example, *Quality Automotive Co. v Signet Bank/Maryland*, 775 F Supp 849 (D Md 1991); *Components Direct v European American Bank*, 175 AD2d 227, 572 NYS2d 359 (1991); and *K.M.C.*, 757 F2d at 759.

26. 757 F2d 752 (6th Cir 1985).

27. *K.M.C.*, 757 F2d at 759.

funds up to the maximum credit limit under a discretionary line of credit, even though the written agreement did not contain any notice provision.²⁸

Irving held a security interest in all of K.M.C.'s accounts receivable and inventory.²⁹ As part of the agreement, all receipts of K.M.C. were to be deposited in a "blocked account" to which Irving would have sole access.³⁰ Consequently, unless K.M.C. obtained alternative financing, a refusal by Irving to advance funds would leave K.M.C. without operating capital.³¹ On March 1, 1982, Irving refused to advance \$800,000 requested by K.M.C.³² This amount would have increased the loan balance to just under the \$3.5 million limit.³³ According to K.M.C., this refusal resulted in the collapse of K.M.C. as a viable business entity.³⁴ K.M.C. contended that Irving's refusal, without prior notice, to advance the requested funds breached a duty of good faith implied in the agreement.³⁵

Following the subjective school of thought, Irving contended that even if there were a duty of good faith, the sole factor determinative of whether it acted in good faith was whether it, through its loan officer, *believed* that there existed valid reasons for not advancing funds to K.M.C.³⁶ Irving argued that it based its decision not on the amount of the security, but on K.M.C.'s capacity to pay back the loan.³⁷ According to Irving, K.M.C. was in a state of financial collapse based on its payables and receivables; therefore, Irving's decision not to advance funds was made in good faith and in the reasonable exercise of its discretion under the agreement.³⁸ Irving reasoned further that this implied requirement to provide notice was inconsistent with the provision in the agreement that all monies loaned were repayable on demand.³⁹

The appellate court was not persuaded by any of Irving's arguments. It asserted that Irving's conduct must be measured by ob-

28. *Id.*

29. *Id.* at 754.

30. *Id.* at 759.

31. *Id.*

32. *Id.* at 754.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.* at 760.

37. *Id.* at 762.

38. *Id.*

39. *Id.* at 759.

jective standards, requiring at least “some objective basis upon which a reasonable loan officer in the exercise of his discretion would have acted in that manner.”⁴⁰ Because there was ample evidence that Irving was adequately secured and thus no losses would be sustained by Irving in the event of liquidation, there was no justification for Irving’s actions in refusing to advance further funds, even if the loan officer believed that K.M.C. was in a state of financial collapse.⁴¹ According to the opinion of the court, as long as the bank is adequately secured, financial collapse of a borrower is never reasonable justification to take action to protect the bank.⁴²

The court’s proposition is not only preposterous, but it totally misses the relevant issue; namely, what was the agreement of the parties regarding refusal to advance funds, and regarding notice in connection with a refusal? By focusing on the implied duty of good faith and using an objective “reasonable loan officer” standard, the court does not attempt to determine the circumstances surrounding the agreement that could provide some indication of the parties’ expectations. As a result, the court, in effect, made the agreement for the parties and failed to provide meaningful guidance for the future.

It is true that the refusal to advance funds under these circumstances proved to be extremely detrimental to K.M.C.; however, borrowers are free to enter into unfavorable agreements, and these agreements should then be enforced. There is nothing inherently “bad” in a bank having significant control over a borrower. It is not uncommon for a bank to maintain complete control over certain borrowers.⁴³ Furthermore, according to banking practices, it would not be unusual for a bank to have such a “tough” deal under circumstances such as those in *K.M.C.*, where a borrower’s accounts are collateral, because “[t]he commercial finance industry traditionally has been tougher in lending against accounts”⁴⁴ On the other hand, if the borrower was in fact led to believe that it would receive notice prior to termination of credit, that, then, is the agreement that should be enforced. Nevertheless, the court did not attempt to determine K.M.C.’s and Irving’s understanding of

40. *Id.* at 761 (emphasis in original).

41. *Id.* at 762.

42. *Id.* at 763.

43. Marilyn M. Barnewall, *Loan Quality Need Not Suffer Because of Aggressive Policies*, *Am Banker* at 23 (May 26, 1987).

44. John F. Dolan, *Fundamentals of Commercial Activity* 274 (1991).

the agreement. And, according to the court, the parties' understanding was irrelevant, because parties are not bound by their agreements, but by what "reasonable" parties would agree to.

C. *The Excluder Analysis*

In one of the earliest and most influential articles on the duty of good faith in contracts, Professor Robert Summers argued that good faith cannot be defined: "[G]ood faith . . . is best understood as an 'excluder'—it is a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith."⁴⁵ A lawyer is to determine what a judge means by using the phrase "good faith" by asking himself, "What does the judge intend to rule out by his use of this phrase?"⁴⁶ Once the relevant form of bad faith is thus identified, the lawyer can, if he wishes, assign a specific meaning to good faith by formulating an "opposite" for the species of bad faith being ruled out.⁴⁷ Summers then provides a survey of particular forms of contractual bad faith.⁴⁸ The closest he gets to a general definition is stating that "[i]n most cases, the party acting in bad faith frustrates the justified expectations of another."⁴⁹

This approach, referred to as the "excluder analysis," was adopted by the Restatement (Second) of Contracts, which acknowledges the implied duty of good faith but, like Summers, gives it no definition. Specifically, section 205 provides that "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."⁵⁰ Comment a adds that the emphasis of good faith is "consistency with the justified expectations of the other party."⁵¹ Comments c and d give examples taken from Summers' article.⁵²

The significance that both Summers and the Restatement place on the justified expectations of a party illustrates the superfluousness of good faith. Summers equates bad faith with frustration of a party's justified expectations, and the Restatement has characterized consistency with these expectations as the 'emphasis' of good

45. Summers, 54 Va L Rev at 196 (cited in note 24).

46. Id at 200.

47. Id.

48. Id at 220-52.

49. Id at 263.

50. Restatement (Second) of Contracts § 205 (1979).

51. Restatement at § 205 comment a.

52. Id at comments c and d.

faith. Nevertheless, protecting the justified expectations of a party does not require implying a duty of good faith; rather, it is a long-standing fundamental principle of contract interpretation which reflects good faith in that it ensures fairness and justice. In most cases, the difficulty is determining and interpreting the agreement to discover what the justified expectations are. Injecting theories of good faith diverts focus from the real issue.

Moreover, cases that have relied upon the excluder analysis as a standard of good faith illustrate that the doctrine of good faith is redundant.⁵³ For example, in *Siegner v Interstate Prod. Credit Ass'n*,⁵⁴ where the court approved of Summers' excluder theory as the correct standard of good faith, two ranchers were suing a credit association claiming breach of contract and breach of the duty of good faith as well. The ranchers were told by the credit association's representative that certain terms in the written agreement were mere formalities and did not represent the true agreement.⁵⁵ The credit association then attempted to rely only on the express terms of the written agreement.⁵⁶ The court acknowledged that the real issue was not good faith, but was the nature of the true agreement, considering all of the surrounding circumstances: "The major underlying issue is whether the evidence of the circumstances surrounding the parties' agreement . . . should have been excluded because of the parol evidence rule."⁵⁷ The court did admit the parol evidence and determined the agreement by considering all of the relevant evidence "concerning the circumstances surrounding the negotiation and execution of the written document."⁵⁸

Notwithstanding the court's admission of the real issue as one of determining the true agreement of the parties, the court still addressed the good faith issue.⁵⁹ The good faith analysis, however, was clearly unnecessary. The court simply repeated its holding

53. See, for example, *Garrett v Bankwest, Inc.*, 459 NW2d 833, 845 (SD 1990) (underlying issue was whether the bank agreed to purchase or redeem the borrower's property after liquidation sale) quoting Summers, 54 Va L Rev at 196 (cited in note 24).

54. 109 Or App 417, 820 P.2d 20, 31 (1991)(approving jury instructions stating that "Good faith . . . excludes a variety of conduct characterized as 'bad faith' because such conduct violates community standards of decency, fairness, or reasonableness. Subterfuges and evasions violate the obligation of good faith . . . It is not possible to catalogue all conduct which might constitute bad faith within the context of a particular contract.") For a discussion of *Siegner*, see notes 135-43 and 235-62 and accompanying text.

55. *Siegner*, 820 P.2d at 23.

56. *Id* at 25.

57. *Id*.

58. *Id* at 27.

59. *Id* at 31.

that the credit association could not rely only on the terms of the written agreement because that did not represent the entire agreement between the parties.⁶⁰

D. *The "Foregone Opportunities" Analysis*

Another commentator on good faith whose theory has had some influence in adjudication of good faith in commercial banking cases is Professor Steven J. Burton.⁶¹ An analysis of Burton's theory also supports the contention that focusing on issues of good faith obfuscates the underlying issues of interpretation and of satisfying the reasonable expectations of the parties. He is in agreement with the thesis of this article, admitting that "courts employ the good faith performance doctrine to effectuate the intentions of parties, or to protect their reasonable expectations, through interpretation"⁶²

Notwithstanding Burton's agreement on this initial point, however, rather than viewing the underlying problem as one of ascertaining the intended agreement and reasonable expectations of the parties by looking beyond the four corners of the written agreement, Burton characterizes the problem of the good faith performance cases as lack of focus.⁶³ He criticizes courts and commentators for not articulating a focused operational standard that distinguishes good faith performance from bad faith performance.⁶⁴ He then provides his own operational standard of good faith:⁶⁵

60. *Id.* at 31-32.

61. Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 Iowa L Rev 497 (1984); Burton, 94 Harv L Rev 369 (cited in note 16). For cases that have applied his standard, see, for example, *Kham*, 908 F2d at 1357; and *State Nat'l Bank v Academia*, 802 SW2d at 293.

62. Burton, 69 Iowa L Rev at 499 (cited in note 61); see also Burton, 94 Harv L Rev at 371 (cited in note 16).

63. Burton, 94 Harv L Rev at 371-72.

64. *Id.* at 369.

65. *Id.* Burton also maintains that based on a survey of over 400 cases, the only cases in which courts explicitly raise the implied covenant of good faith are discretion cases; that is, cases in which the parties deferred decision on a particular term or in which there is a lack of clarity because of an omission in the express contract. *Id.* at 380. This may have been true in 1980 when Burton wrote his article, but it certainly is not the case now. Burton's characterization of the good faith cases does not accurately represent the lender liability cases which are the subject of this article. The cases surveyed for this article show that the cases discussing or applying the implied duty of good faith are cases in which the parties disagree over the nature of the agreement. Usually, the borrower is relying on evidence extrinsic to the written agreement to determine the true agreement, and the bank is relying only on the express terms of the written agreement. *Id.*

Good faith limits the exercise of discretion in performance conferred on one party by the contract. When a discretion-exercising party may determine aspects of the contract, such as quantity, price or time, it controls the other's anticipated benefits . . . Bad faith performance occurs precisely when discretion is used to recapture opportunities foregone upon contracting—when the discretion-exercising party refuses to pay the expected cost of performance. Good faith performance, in turn, occurs when a party's discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation—to capture opportunities that were preserved upon entering the contract, interpreted objectively.⁶⁶

Burton suggests two questions to ask to determine whether the discretion-exercising promisor breached a contract by using its discretion in bad faith: (1) at formation, what were the reasonably expected costs of performance (foregone opportunities) to the discretion-exercising promisor and (2) at performance, did the discretion-exercising promisor use its discretion to recapture an opportunity foregone on contracting?⁶⁷ The first question focuses attention on the time of formation, and is an objective inquiry into the reasonable expectations of the promisee as to opportunities foregone by the discretion-exercising promisor by contracting. The second question is an inquiry into subjective intent at the time for performance. Having made these determinations, one then can conclude with reasonable certainty whether the dependent party's claim that it did not receive what it was entitled to is sound.

Burton's standard again illustrates the superfluosity of the doctrine of good faith. The standard articulated by Burton does not distinguish good faith functionally⁶⁸ from the purpose of the objective theory of contracts, protecting the reasonable expectations of the parties. More importantly, it does not focus on the problematic area in the cases, namely, how a court should ascertain the reasonable expectations of the parties. Although Burton directs courts to focus only upon the facts that relate to the opportunities foregone by the discretion-exercising party at formation, he provides no guidance as to how a court determines these foregone opportunities. He even questions whether his own theory is workable. He is not sure whether it is possible to determine the identity of foregone opportunities in a particular case.⁶⁹ Moreover, by advising

66. Burton, 94 Harv L Rev at 372-73 (cited in note 16).

67. Burton, 69 Iowa L Rev at 506-07 (cited in note 61).

68. *Id.* at 511.

69. *Id.* at 507 n 41. He does, however, seem to contradict himself in an earlier footnote in which he explains that he "think[s] that the good faith performance cases typically are cases in which the reasonable expectations of the parties can be reasonably ascertained,

courts to focus only upon specific facts, even when determining specific reasonable expectations, Burton's analysis is too limited in scope. When interpreting a contract and determining the reasonable expectations of the parties, one must look at all of the surrounding circumstances to put specifics in context.

Burton does, however, support this article's premise that courts must go beyond the four corners of the document to determine the parties' agreement and expectations. He does this by implication, in a footnote, when he maintains that: "Express language accordingly will fail to set forth all of the specific undertakings of the parties."⁷⁰ This statement accurately describes the problem. The express terms of the written agreement fail to manifest the intended agreement; therefore, courts must look beyond the express terms. Unfortunately, it appears from Burton's statements referring to "express" language and "express" contract that he (like many courts)⁷¹ believes that only the express terms manifest promise. This belief is erroneous. Cases that have presumably used Burton's standard illustrate this point.⁷²

For example, in *State National Bank ("Bank") v Academia, Inc.*,⁷³ a Texas appellate court, applying Burton's standard, considered only the express terms of the written contract in ascertaining the expectation of the parties. In *Academia*, the Bank sued Academia, the borrower, for a deficiency under a note.⁷⁴ Academia alleged that there was an oral agreement with the Bank that the note due on its face on October 30, 1986 would not have to be fully

using an objective theory of contract interpretation . . ." Id at 500 n 18. This, as this article has been arguing, is the main problem and should be the focus of the cases.

70. Burton, 94 Harv L Rev at 380 n 44 (cited in note 16).

71. See, for example, *Savers Fed. Sav. & Loan Ass'n v Home Fed. Sav. & Loan Ass'n*, 721 F Supp 940, 943 (WD Tenn 1989)(asserting that the parties' agreement is evidenced by the "signed documents, especially in the world of commercial loans"); *Flagship Nat'l Bank v Gray Distrib. Sys., Inc.*, 485 So2d 1336, 1340-41 (Fla Dist Ct App 1986)(relying only on the express provisions of the written loan agreement); *First Sec. Bank of Idaho v Gaige*, 115 Idaho 172, 765 P2d 683, 686-87 (1988)(holding that "real deal" consists only of written guaranty); *Shiplot v First Sec. Bank of Livingston, Inc.*, 234 Mont 166, 762 P2d 242, 245 (1988); *Garrett v Bankwest, Inc.*, 459 NW2d 833, 845 (SD 1990) (emphasizing the "plain language" of the written agreement); *Kham*, 908 F.2d at 1357 (relying only on the express terms of the written contract).

72. See, for example, *State Nat'l Bank v Academia*, 802 SW2d at 282; *Kham*, 908 F2d at 1357 (stating that "'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting . . .") See notes 168-98 and accompanying text for a detailed discussion of *Kham*.

73. 802 SW2d 282 (Tex Ct App 1990).

74. *Academia*, 802 SW2d at 286.

repaid until after the 1987 selling season.⁷⁵ The Bank began foreclosure in December 1986; therefore, Academia claimed that the Bank acted in bad faith by breaching its alleged oral agreement not to call the note before the end of the 1987 selling season.⁷⁶ The borrower argued that oral evidence was necessary "as an aid to construing [the contract]," and the jury believed and found for the borrower.⁷⁷ The appellate court, however, explained the duty of good faith and fair dealing as follows: "The duty applies not in an overarching fashion, covering every aspect of the parties' relationship, but rather it limits one party's discretion *where a contract gives the party that discretion* . . . The Illinois courts do not use the duty to overcome the parties' expectations"⁷⁸ Holding for the Bank, the appellate court reasoned that Academia's claims could not form the basis for breach of the covenant of good faith and fair dealing because it "would be contrary to the written contract."⁷⁹

That the claim based on good faith is unnecessary is established by the fact that Academia also claimed breach of contract based on the "oral agreement" that the Bank would postpone collecting on the note. Furthermore, focusing on good faith diverts focus from the real issue: did the Bank, through any of its manifestations of intent, lead Academia reasonably to expect that it would not require payment until after the 1987 selling season? To answer this question, one must consider and weigh all of the evidence, as the lower court did, not just the express terms of the written agreement.

E. *The "Hypothetical Reconstruction" Analysis*

One commentator, Dennis Patterson, who has written several articles and a book on the subject of good faith and lender liability, also recognizes that the real question is "What is the Agreement of the Parties?"⁸⁰ and agrees that the traditional notion of "reasonable expectation" is the core of good faith.⁸¹ Notwithstanding his

75. Id at 288.

76. Id.

77. Id at 292.

78. Id at 293 (emphasis in original).

79. Id at 294.

80. Patterson, *Good Faith and Lender Liability* at 143 (cited in note 16). See also Dennis M. Patterson, *Wittgenstein and the Code: A Theory of Good Faith Performance and Enforcement Under Article Nine*, 137 U Pa L Rev 335 (1988); and *A Fable From the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 Iowa L Rev 503 (1991).

81. Patterson, *Good Faith and Lender Liability* at ix (cited in note 16).

recognition of the underlying issue as one of determining the agreement of the parties in order to fulfill the reasonable expectations of the parties, Patterson, as all of the other theorists, diverts focus from this issue and goes on to articulate a "test" to determine good faith. He claims that this test "defines the parameters within which triers of fact can decide between competing reconstructions of the agreement of the parties."⁸²

Patterson's test to determine good faith is to ask, "Given what the parties each knew, and with a full appreciation of the several sources for the meaning of the original Agreement, which of the two proposed reconstructions of the meaning of the original Agreement is consistent with the original materials?"⁸³ There are several problems with this test. First, Patterson does not provide any elaboration on his test to aid the fact finder, whom he assumes will always be the jury. Second, Patterson also assumes contrary to the assumptions of most commentators,⁸⁴ that "lay juries are competent to judge the 'reasonableness' of commercial practices."⁸⁵ Third, his test fails to inform the jury what they are to consider when they consider "what party each knew." In addition, Patterson does not delineate the sources that the members of the jury are to "fully appreciate." Finally, assuming the jury has these sources and knowledge, Patterson does not articulate the "original materials" with which the proposed reconstruction is to be consistent.

Moreover, when Patterson applies his test to *K.M.C.*,⁸⁶ he seems

82. Id at 152. Another problem with Patterson's analysis is that theoretically it would be irrelevant in many cases. Patterson believes that reconstruction of the meaning and content of the concept of good faith must begin with consideration of the Uniform Commercial Code's (the "Code") definition of the term in section 1-203. He seems to conclude that the Code governs because the transaction involves a secured transaction under Article 9. He then goes into a very long, involved analysis of the Code. However, the Code will not always be applicable for several reasons. First, not all commercial transactions are secured transactions. "Unsecured loan agreements are not unusual in commercial banking . . ." Dolan, *Fundamentals of Commercial Activity* at 274 (cited in note 44). Second, even if a transaction is secured by collateral, the collateral may be only real estate which is not governed by the Code. Third, many times the main agreement governing the relationship between the lender and the borrower and, consequently, the agreement that is the subject of litigation, is the loan agreement, which is not governed by the Code. Id at 272. Only the note (if negotiable), the security agreement, and the financing statement are defined and governed by the Code. The note would come under Article 3, and the last two documents would be under Article 9. Thus, unless a judge applies the Code by analogy, Patterson's analysis would theoretically be irrelevant in many cases.

83. Patterson, *Good Faith and Lender Liability* at 149 (cited in note 16).

84. See, for example, Alvin B. Davis, *The Case Against Juries in Lender Liability*, ABA Banking J 184 (Oct 1987); and note 110.

85. Patterson, *Good Faith and Lender Liability* at 154 (cited in note 16).

86. Id at 151. For a discussion of *K.M.C.*, see notes 26-42 and accompanying text.

to apply a different test that deliberately ignores the actual agreement of the parties. In his analysis of *K.M.C.*, he posits the relevant question as, "Is it reasonable for a business person engaged in this sort of enterprise to agree to a financing arrangement whereby the lender could put the borrower out of business with impunity and with no reasonable business motive?"⁸⁷ His phrasing of the question is clearly biased and argumentative. Obviously, the only answer that a lay jury would give to Patterson's phrasing of the question is "of course not." Many of the relevant facts are missing, such as the circumstances surrounding the making of the agreement and the circumstances surrounding the lender's refusal to advance further funds. More importantly, the answer to Patterson's question will not lead the jury to search for the parties' intended agreement. Rather, the question permits the jury to develop an agreement on their own. The parties are forced to comply with an agreement that the jury believes is a "commercially reasonable" one.

Patterson would have the jury listen to two "hypothetical" reconstructions and decide which one sounds more commercially reasonable. However, if the goal is to satisfy the purposes of contract law, the task for the jury should be to search for the agreement of the parties. Thus, the question in *K.M.C.* should be, "Did Irving manifest any intention to K.M.C. to lead K.M.C. to reasonably expect that Irving would continue financing K.M.C.'s business provided that Irving remained adequately secure, or, on the other hand, did Irving lead K.M.C. to reasonably expect that Irving would have discretion to refuse funds if Irving thought that K.M.C.'s capacity for repayment of the loan was impaired?" Recall that Irving claimed that K.M.C.'s deteriorating financial condition was the reason for its refusal to advance funds.

Patterson's test is based on the assumption that a bank and a borrower cannot have any shared expectations because they share no basis on which to ground judgments about their (un)common experiences. Therefore, it makes no sense to direct a court to inquire into the reasonableness of the parties' expectations only to find that they share no common experiential basis. He contends that small businesspersons cannot be expected to know the meaning of terms from an "insider's" perspective. Since they lack a common basis of understanding with the lender, the borrower cannot be held to the same standard of "reasonableness" as the

87. Patterson, *Good Faith and Lender Liability* at 151 (cited in note 16).

lender.⁸⁸ He believes that the specific problem is that the expectations of the parties are not thoroughly spelled out at the time the express terms are agreed to: "The problem comes when one party seeks to effectuate or act on an inchoate expectation which, when brought to the attention of the other party, causes that party to react with claims of understanding (the terms of the Agreement) inconsistent with that (other) inchoate expectation."⁸⁹ This, however, is not the case.

Patterson's assumptions and conclusions are faulty. First, the problem usually arises when the borrower seeks to act on an expectation that was induced by the bank that cannot be found merely by looking at the four corners of the written document. As the cases discussed in this article illustrate, in many situations, the meaning that is being disputed was manifested to the borrower at the time of formation. The assumption that the borrower and lender have no shared expectations is not justified. A review of the cases shows that in many instances, the borrowers, had extensive experience in financing, and usually had ongoing relationships with the bank.⁹⁰ Therefore, they would have some shared expectations and common experiences. Also, even with a first-time borrower, the cases disprove the assumption that the bank merely presented the borrower with a contract and the borrower signed it without any understanding of the details of the transaction.⁹¹

It seems unlikely that a borrower would sign a demand note for a significant amount of money (such as \$3.5 million in *K.M.C.*), and give the bank total control over the cash flow of his business, without discussing the terms with the banker at all. This is, however, what Patterson would lead us to believe. For example, he states that "the only clear or conscious expectation on the part of the officers of the company [in *K.M.C.*] was that their operations would be financed by Irving so long as they continued to make their payments under the line of credit agreement."⁹² However, he provides no evidence to support this contention.

Furthermore, if we are to believe Patterson's other premise, that

88. *Id.* at 144.

89. *Id.* at 148.

90. See, for example, *Kham*, 908 F2d at 1353-54 (July 1981 to February 1984); *First Sec. Bank of Idaho*, 765 P2d at 684 (1978 to 1983); *Shiplet*, 762 P2d at 243-44 (The court stated that the borrowers "have done business with the Bank for a number of years."); and *Weinberg*, 752 P2d at 722-23 (borrowers were engaged in financing activities from at least 1968 to 1974).

91. See, for example, *Siegner*, 820 P2d at 23.

92. Patterson, *Good Faith and Lender Liability* at 148 (cited in note 16).

the debtor relies on ordinary life experience, not commercial sophistication,⁹³ then we would have to conclude that the ordinary meaning of the agreement is the meaning the debtor would have assumed. If the debtor could not be expected to know the meaning of terms from an "insider's" perspective, and cannot be held to the same standard of "reasonableness" as the lender, then the meaning of the terms must be their plain ordinary meaning. If this is true, then it must follow that *K.M.C.*, as an unsophisticated debtor, would interpret "demand" as demand based on ordinary life experiences, and would interpret the term "discretion" which gave Irving total discretion to advance funds to mean Irving had no restrictions. An ordinary, unsophisticated borrower who is not familiar with bank practices would not know the banker's special meaning for "demand" unless the banker so informed the borrower. Similarly, an ordinary, unsophisticated borrower would not know the banker's special meaning of "discretion" unless so informed.

It does not matter that the parties do not have "shared expectations" in the sense that they are both sophisticated and knowledgeable in the business of banking. What matters is what the bank led the borrower to believe through its outward manifestations. The fact that a person is a small businessperson and not a "sophisticated" financier does not mean that, at the time of the agreement, the bank and the borrower did not reach an understanding about crucial terms that could have a significant impact upon the continuing viability of the business.

In addition, even if the disagreement is over a term that was not, as Patterson characterizes it, "thoroughly spelled out,"⁹⁴ there is still no reason to let the fact finder impose upon the parties its idea of the most commercially reasonable agreement. The purpose of interpretation is to determine the meaning that the borrower gave to the bank's expressions, and to determine whether the bank knew or should have known what the borrower understood. A party should not be bound by a meaning not manifested by words or conduct. Thus the fact finder should search for the meaning given to the words by the parties even though not "sufficiently spelled out."

Specifically, in *K.M.C.*, the fact finder should have attempted to determine whether Irving manifested any expressions that it had

93. Id at 145.

94. Id at 148.

reason to know would be understood by K.M.C. to mean that Irving would not refuse to advance funds provided that K.M.C. continued to make timely payments on the interest, and provided that Irving was adequately secured. If K.M.C. could not present any relevant, credible evidence showing any such manifestation on Irving's part, Irving should not have been bound by the agreement even if it seemed to be the most "commercially reasonable." If K.M.C. could not present any evidence that Irving gave a meaning to the agreement other than the usual meaning, or that Irving had any reason to know that K.M.C. did so, then the express terms of the written agreement were what should have been given effect. They should have been given effect, however, because they were the only manifestation of intent, not because the written word is the only source of meaning. Furthermore, a court should always test its conclusion that the express terms of the writing manifest the agreement by going back to the bargaining and negotiating stage to determine whether the parties were in fact using the words in the usual context. More likely than not the lender will have manifested some intent as to the meaning of crucial terms. For example, although not ever mentioned in the court's analysis, Irving's answer to K.M.C.'s complaint provided some information as to the circumstances surrounding the making of the agreement.⁹⁵ If this information had been pursued, other information would probably have been discovered to aid the court in determining the intent of the parties relating to the circumstances under which Irving could refuse to advance funds.

It can be seen, then, that Patterson does not focus on a search for the true agreement. He creates a hypothetical scenario which may or may not coincide with the actual agreement of the parties. Furthermore, even though a court should not rely totally upon the express terms of the written agreement, neither should the agreement be totally ignored, which is the result with Patterson's approach. If no evidence, intrinsic or extrinsic, is presented to negate the written agreement, then the written agreement is all that the courts should be able to enforce. However, the borrower should first have an opportunity to present evidence of any outward manifestations of the lender that led the borrower to believe that the agreement was something other than the plain meaning of the written agreement. The job of the fact finder in commercial lend-

95. Answer of Defendant (*K.M.C. Co., Inc. v Irving Trust Co.*), reprinted in H. Chaitman, *Emerging Theories of Lender Liability*, 1 ABA 587, 588-91 (1985).

ing cases, as in other cases, is to find the truth. The fact finder, whether judge or jury, must reach a conclusion as to the true agreement of the parties, based on all the facts surrounding the making of the agreement. The fact finder's job is not to listen to two hypothetical stories and decide which one sounds more reasonable: sometimes the true agreement is not the most reasonable agreement (even though it may be reasonable in the context of particular circumstances).⁹⁶

II. THE CONTRADICTORY LAW OF CONTRACT VERSUS REALITY IN THE WORLD OF COMMERCIAL LENDING

The recent explosion of the use of the implied duty of good faith in lender liability cases is a phenomenon comparable to a similar phenomenon explained in the late Grant Gilmore's "Death of Contract."⁹⁷ Professor Gilmore asserted that equitable contract principles such as promissory estoppel, quasi-contract, substantial performance, and impossibility of performance developed to protect individuals who, under classical contract theory (particularly the "bargain" theory of consideration), would otherwise have been deprived of protection.⁹⁸ For example, Gilmore averred that promissory estoppel was originally used to protect those who had relied to their detriment on precontractual or noncontractual representations.⁹⁹ Similarly, Gilmore argued that courts turned to the quasi-contract theory to protect individuals who had conferred benefits on another who had not voluntarily assumed contractual obligations.¹⁰⁰ Substantial performance, on the other hand, developed, according to Gilmore, to protect individuals who had started but had not quite completed performance, or whose performance was defective in some minor way.¹⁰¹ Finally, Gilmore explained that the doctrine of impossibility of performance arose to prevent the injustice of the rule of absolute contractual liability.¹⁰²

All of these doctrines or theories were "necessary to promote the ends of justice" against classical contract law in which the emphasis was on formalism, certainty of meaning, and freedom of con-

96. Restatement (Second) of Contracts § 203 comment c (1979).

97. Grant Gilmore, *The Death of Contract* at 72-74 (Ohio State University Press, 1974).

98. Gilmore, *The Death of Contract* at 63-64, 72-74, 80 (cited in note 97).

99. *Id.* at 72.

100. *Id.* at 73-74.

101. *Id.* at 74.

102. *Id.* at 80-81.

tract.¹⁰³ Unless the formalities were observed, there could be no contract, and consequently, no liability.¹⁰⁴ For example, the bargain theory of consideration offered a means of escape from the imposition of contractual liability,¹⁰⁵ and prevented recovery to a promisee who suffered a detriment or conferred a benefit on another because there was no "reciprocal conventional inducement, each for the other, between consideration and promise."¹⁰⁶ Likewise, formalistic rules, such as (1) the parol evidence rule;¹⁰⁷ (2) the plain meaning rule, which requires consideration only of the plain meaning of the express terms of the written contract;¹⁰⁸ and (3) the rule requiring definiteness and certainty of terms,¹⁰⁹ all of which emphasize the *written* agreement over other manifestations of intent, offered a means of escape to banks. Banks could hide behind the formalism of the rules to prevent recovery to a borrower who relied on manifestations of intent beyond the express terms of the written agreement. Similarly, the equitable principle of good faith has come into fashion in commercial loan cases as a way to prevent unjust results caused by the existing formalism in contract law.¹¹⁰

103. *Id.* at 74. See also Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA L Rev 829, 829-36 (1983).

104. Gilmore, *The Death of Contract* at 20 (cited in note 96).

105. *Id.*

106. *Id.*

107. For good faith cases that have applied the parol evidence rule, see, for example, *First Sec. Bank of Idaho*, 765 P2d at 686-87; *Shiplet*, 762 P2d at 245; and *Academia*, 802 SW2d at 291.

With regard to the parol evidence rule, it has been described by some commentators as: "philosophically indefensible," (Levinson, 60 Tex L Rev at 378 n 18 (cited in note 11)); "troubling and controversial" (McIntosh, 35 Okla L Rev at 44 (cited in note 11)); and "familiar to many but fathomed by few" (John E. Murray, Jr., *Murray on Contracts* § 82 at 376 (3d ed 1990)). Any argument for its use can be easily refuted. The rule, it is said, protects the written agreement and provides that the borrower may not vary or expand the agreement by introducing parol evidence to show understandings or antecedent agreements which are in some way contrary to the terms of the contract. Restatement (Second) of Contracts § 205. Moreover, as Professor Murray explains in his clarification of the parol evidence rule, it is not really a rule of interpretation because it only determines what constitutes the agreement. It does not tell us how to determine what words mean. However, courts apply it incorrectly as a rule of interpretation. See John E. Murray, Jr., *The Parol Evidence Rule: A Clarification*, 4 Duq L Rev 337, 338 (1965-66).

108. For good faith cases that have applied the plain meaning rule or a variation, see, for example, *Mirax Chem.*, 950 F2d at 569; *Kham*, 908 F2d at 1357; *Flagship Nat'l Bank*, 485 S2d at 1340-41; and *Garrett*, 459 NW2d at 845.

109. For good faith cases that have required more certain and definite terms, see, for example, *Union State Bank v Woell*, 434 NW2d 712, 717 (ND 1989); *Siegner*, 820 P2d at 28-29; and *Garrett*, 459 NW2d at 839.

110. Professors McCormick and Wigmore attribute the survival of formalism in the area of the parol evidence rule to the mistrust of juries. Charles T. McCormick, *The Parol Evidence Rule as a Procedural Device for Control of the Jury*, 41 Yale L J 365, 369 n 8

The problem with the existing formalism is that it erroneously assumes a society "composed of independent, freedom-seeking individuals, each of whom avidly pursues his own self-interests,"¹¹¹ is highly responsive to the incentive or threat of contract rules,¹¹² and enters into transactions only after "careful bargaining."¹¹³ Additionally, just as the classical contract principles discussed by Gilmore "had nothing to do with the real world,"¹¹⁴ neither do the formalistic rules, which elevate the importance of the written document in the lender liability cases, reflect the realities of present day banking practices. Notably, when the transaction underlying the agreement at issue is a commercial loan transaction, courts and commentators stress the importance of the writing more than in other transactions.¹¹⁵

The reasons given by courts and commentators for applying the formalistic rules tend to be some variation of the unfounded, unproven fear that, at worst, banks will stop lending money if they cannot rely solely upon the written language in their agreements, or, at best, the cost of lending money will increase to the point that marginal borrowers will never be able to obtain a loan.¹¹⁶ In other words, banks must be able to rely upon the illusion of certainty and predictability of the written word whether it accurately represents the agreement or not; otherwise, economic life as we now

(1932). This premise is supported by the virtual disappearance of the parol evidence rule in modern English law, concomitant with the virtual disappearance of the use of jury trials. See generally P.S. Atiyah, *Essays on Contract* 116 (Oxford University Press 1986) on the disappearance of the parol evidence rule. See generally Terence Ingman, *The English Legal Process* 16 (3d ed 1990) and R.J. Walker, *The English Legal System* 245 (6th ed 1985) on the disappearance of jury trials.

Mistrust of the jury also explains retention of the rules which give effect to the plain meaning of the express terms of the written contract. Only if interpretation of a contract depends on extrinsic evidence will the trier of fact be required to perform. John E. Murray, Jr., *Murray on Contracts*, § 86 at 405-06 (3d ed 1990) (cited in note 107).

111. Feinman, 30 UCLA L Rev at 832 (cited in note 103).

112. Id at 844.

113. Id at 855.

114. Gilmore, *The Death of Contract* at 7 (cited in note 96).

115. See, for example, *Savers Fed. Sav. & Loan v Home Fed. Sav. & Loan*, 721 F Supp 940, 943 (WD Tenn 1989) ("Typically, agreement is evidenced by signed documents, especially in the world of commercial loans").

116. For cases and commentary espousing or discussing this view, see, for example, *Fasolino Foods Co., Inc. v Banca Nazionale Del Lavoro*, 961 F2d 1052, 1057 (2d Cir 1992); *Badgett v Security State Bank*, 116 Wash 2d 563, 807 P2d 356, 361 n 3 (1991); David Charny, *Nonlegal Sanctions In Commercial Relationships*, 104 Harv L Rev, 374, 457 (1990); Janine S. Hiller, *Good Faith Lending*, 26 Am Bus L J, 783, 802 (1988); Comment, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U Chi L Rev, 1335, 1338 (1988).

know it will cease to exist.¹¹⁷ This premise has never been substantiated. In fact, the evidence available from a similar premise indicates that this argument is fallacious.

In the 1960's, new regulations were adopted which preserved consumer claims and defenses against a holder in due course who purchased a negotiable instrument relating to a consumer transaction.¹¹⁸ Opponents gave "dire warnings" that consumer credit would dry up without holder in due course immunity."¹¹⁹ As the current exorbitant amount of consumer debt illustrates,¹²⁰ this dire prediction, which also had no factual support, was never realized.¹²¹ (Perhaps many consumers and the economy would be in better financial shape if it had.)

In addition, because so many variables affect the decision of a bank loan officer to lend money,¹²² it is not reasonable to argue that only one variable, particularly the law of contract, will be the deciding factor, if it is a factor at all. In fact, the following factors are listed as "Typical factors a loan officer considers: 'He cheats on his wife.' 'He wears white shoes.' 'He is too ready to buy the drinks.' 'Never lend to a _____ [insert 'plumber,' 'lawyer,' 'salesman,' or other category of business person that has burned the loan officer in the past].'"¹²³

Nevertheless, it is the position of this article,¹²⁴ that one of the main reasons for the "overriding sacredness of the documentation"¹²⁵ is that courts are unfamiliar with the way bankers and commercial borrowers actually contract. As Professor Murray asserts: "In such cases [where judges and lawyers lack familiarity with the type of transaction underlying the agreement], there is a tendency to ignore the realities of the surrounding circumstances

117. See Stewart Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 Law & Soc'y Rev, 507, 523 (1977).

118. Ellen R. Jordan, "Just Sign Here - It's Only a Formality": Parol Evidence in the Law of Commercial Paper, 13 Ga L Rev 53, 59 (1978).

119. Jordan, 13 Ga L Rev at 59 (cited in note 118).

120. Abstract, *U.S. Household Debt Grew Substantially*, Wall St J at A8 (April 10, 1991).

121. White & Summers, *Uniform Commercial Code* § 14-1 at 614 (cited in note 23).

122. See for example, Gene R. Barrett, *What Bankers Want to Know Before Granting a Small Business Loan*, Journal of Accountancy 47 (Apr 1990) ("Bankers use the 'six C's of credit (to evaluate a borrower) — credit, capital, coverage, capacity, circumstances, collateral and character."); Louis Uchitelle, *Bankers Expected to Stay Hesitant to Lend for Years*, N Y Times at A1 col 6 (July 5, 1991) ("Many factors affect a bank's willingness to lend, from the health of the bank to the size of its underlying capital base.")

123. Dolan, *Fundamentals of Commercial Activity* § 12-3 at 266 (cited in note 44).

124. See note 7 and accompanying text.

125. Murray, 51 Or L Rev at 296 (cited in note 7).

and cling to the documents as sacred . . . [C]ourts resort to documents exclusively where they are totally unfamiliar with the behavior patterns of the parties in a particular transaction."¹²⁶ Furthermore, determining the agreement by considering all of the circumstances surrounding the making of the agreement is, in fact, a very difficult task requiring "severe discipline" and the "irritable reaching after fact and reason."¹²⁷ Obviously, it is much easier mechanically to determine the "plain" meaning of the express terms of the written agreement, or creatively to decide what the equitable, reasonable agreement demonstrating good faith would be than to gather and weigh all of the evidence relating to the circumstances under which the agreement was made.

Despite the various reasons for applying the formalistic rules, however, any satisfactory method of interpreting commercial loan agreements must acknowledge that much significant economic behavior takes place almost untouched by contract norm. Few nonlawyers know much about or pay much attention to the content of the formal norms when they negotiate agreements.¹²⁸ The empirical picture of the contract process differs sharply from the classical model which assumes that contracts are carefully drafted and negotiated with input from both parties, and that the parties have read it, have understood it, and have understood that their agreement is based upon the literal meaning of the express terms of this written contract.¹²⁹

Instead, many times, the written terms are ignored or are used in a way that does not reflect their literal, plain meaning. The borrower's understanding of the agreement is based upon oral statements from the loan officer representing the bank, who tells the borrower that certain language can be ignored, or that the language means something other than its plain, literal meaning. Many times the borrower is led to believe that the terms used are just a formality.

For example, in *First Security Bank of Idaho (the "Bank") v Gaige*,¹³⁰ the owner of a business signed a personal guaranty to guarantee payment of his company's debt. He was told by the

126. *Id.* at 290-91.

127. Hirsch, *Validity in Interpretation* at ix (cited in note 8).

128. See generally Macaulay, 11 *Law & Soc'y Rev.* at 523 (cited in note 117); Charny, 104 *Harv L Rev.* at 376 (cited in note 116); and Feinman, 30 *UCLA L Rev.* at 851 (cited in note 103).

129. Macaulay, *Law & Soc'y Rev.* at 508-09 (cited in note 117).

130. 115 *Idaho* 172, 765 P2d 683 (1988).

Bank's loan officer that the guaranty was a mere formality; the Bank would satisfy the company debt from company assets before pursuing payment under the guaranty.¹³¹ Nevertheless, the Bank later demanded payment under the personal guaranty before exhausting all of the company's assets.¹³² When the guarantor sued and tried to admit the loan officer's statements, both the trial court and the appellate court held that the statements were not admissible under the parol evidence rule because they would modify the terms of the written agreement.¹³³ In addition, in response to the guarantor's claim that the Bank breached its duty of good faith, the court ruled that it did not breach any duty "by merely exercising its express rights under the guaranty agreement."¹³⁴

Similarly, in *Siegner v Interstate Prod. Credit Ass'n* ("Interstate"),¹³⁵ two ranchers, whose business was solicited by Interstate's loan officer, were told that the fact that their loan was structured for one year was a formality and that Interstate would roll over the balance from year to year under the same terms until the loan was paid off. The ranchers were assured that Interstate was prepared to stay with the plaintiffs for the "long haul."¹³⁶ Also, the ranchers were told that the language requiring them to inject cash into the ranch if the loan margin fell below acceptable levels was a mere formality and nothing to worry about.¹³⁷ Notwithstanding these comforting words of assurance, every time the loan came up for annual renewal, the bank changed the relationship or imposed new conditions on the ranchers.¹³⁸ Finally, after about seven renewals and seven concomitant changes, when the bank began to demand liquidation of cattle, the ranchers sued the bank claiming breach of the implied duty of good faith.¹³⁹ The defense was typical of banks caught in this type of situation: the bank claimed that the implied duty of good faith claim should have been excluded because if the bank's performance was in compliance with the written documents, it could not have been in bad faith.¹⁴⁰

Despite the good faith claim (which, as is normally the case, was

131. *Gaige*, 765 P2d at 686.

132. *Id.* at 684.

133. *Id.* at 686-87.

134. *Id.* at 687.

135. 190 Or App 417, 820 P2d 20 (1991).

136. *Siegner*, 820 P2d at 23.

137. *Id.*

138. *Id.* at 24.

139. *Id.* at 24-25.

140. *Id.* at 31.

unnecessary), the court recognized that the major underlying issue was the parol evidence rule; that is, whether evidence of the circumstances surrounding the agreement and of the alleged oral agreement should have been excluded.¹⁴¹ The court then engaged in a lengthy, complex analysis under the parol evidence rule in order to permit the evidence extrinsic to the written agreement, and concluded that the bank breached the alleged oral agreement.¹⁴² With respect to the superfluous good faith claim, the court's response to the bank's defense was basically that a breach of the duty of good faith could be found because the bank breached the alleged oral agreement.¹⁴³

Conversely, in *Shiplot v First Security Bank of Livingston*¹⁴⁴ (the "Bank,") the Montana Supreme Court based its opinion only on the written document and ruled against the borrower. The agreement between the Bank and the Shiplotes was in the form of a one-year promissory note at an interest rate of ten percent.¹⁴⁵ Apparently, the Bank led the Shiplotes to believe that the terms in a "Request for Guarantee" to the Farmers Home Administration ("FmHA") would also be the terms of the agreement between the Bank and the Shiplotes, including the term which provided for a ten percent rate of interest for five years.¹⁴⁶ After the first note, the parties entered into a cycle of notes, most of which were issued for six-month terms.¹⁴⁷ The interest rate on subsequent notes fluctuated as the prime lending rate rose and fell, reaching a peak of twenty-one and one-half per cent.¹⁴⁸ When the Shiplotes sued for breach of contract, the court would not admit any of the Bank's statements regarding the five-year interest rate agreement because the "oral representations made by the Bank prior to signing [the note] merged with the note's terms."¹⁴⁹ Despite the court's admission that the bank made statements that were "not always strictly forthright,"¹⁵⁰ the court would not admit any evidence supporting the five-year agreement because it was "evidence of prior oral agreements [which] is not admissible for the purpose of altering

141. Id at 25.

142. Id at 25-28.

143. Id at 31-32.

144. 234 Mont 166, 762 P2d 242 (1988).

145. *Shiplot*, 762 P2d at 244.

146. Id.

147. Id.

148. Id.

149. Id at 245-46.

150. Id at 246.

subsequent written agreements dealing with the same subject.”¹⁵¹ The court concluded that the only agreement between the parties was the written promissory note for one year and, since raising the interest rates was not a violation of the guaranty with the FmHA, the Bank was not prohibited from raising the interest rate after the one year note terminated, despite the Bank’s oral statements which were not always “forthright” with the Shiplets about the future interest rates.¹⁵²

In addition to claiming breach of contract, the Shiplets also claimed that the bank breached the implied duty of good faith.¹⁵³ This claim of course was unessential since the court characterized the “gravamen” of the claim as whether the terms of the agreement were carried out faithfully.¹⁵⁴ Obviously, this is no different than the breach of contract claim, and begs the threshold question; namely, what is the agreement? Again relying on the express terms of the written note, the court simply proclaimed that:

[T]he various notes evidencing agreement between the Bank and the Shiplets were in fact carried out by the Bank. The monies agreed upon were advanced at the rates agreed upon in writing by both parties. Statements made by the Bank’s agent, while not always strictly forthright, did not deprive Shiplets of the benefit of the bargains they struck with the Bank.¹⁵⁵

Cases similar to the three cases described above, in which borrowers are led to believe that the express terms of the written agreement are not representative of the true agreement, reflect the realities of the commercial world where “businessmen are inclined to believe soothing words from too helpful bankers.”¹⁵⁶ Moreover, even the statements of bankers and commentary directed to bank loan officers indicate that loan officers do not take the language in loan agreements literally, and that the non-literal meaning is conveyed to and taken seriously by the borrowers. For example, one bank president testified, “based on his knowledge of banking practices,” that in the absence of a time term in a demand note, the likelihood was that the schedule for repayment of the principal was governed by a verbal agreement between the loan officer and the

151. Id at 245.

152. Id at 246.

153. Id.

154. Id.

155. Id.

156. Jordan, 13 Ga L Rev at 78 (cited in note 118). See also Charny, 104 Harv L Rev at 458 (cited in note 116)(arguing that borrowers may misapprehend the nature of the lending relationship and that such misapprehension may often be encouraged by lenders).

debtor.¹⁵⁷ Similarly, another bank president testified that a banker is required to give notice before termination of financing, even if the written document does not require notice.¹⁵⁸ Furthermore, the *United States Banker* warns: "Make certain that legal documents clearly reflect the understandings between the parties. Telling a borrower that provisions of the agreement 'aren't really enforced,' or 'are just there for the lawyers' is a big mistake."¹⁵⁹

Despite these words of warning, the cases discussed¹⁶⁰ indicate that bank loan officers do make oral representations in violation of the advice set forth above. Then, when the borrower relies on these oral representations, the bank will "scrambl[e] for a loophole, a tactic, which violates the expectations that the other party views as justified."¹⁶¹ Almost always the bank will want the court to determine the agreement based on the plain meaning of the express terms of the written agreement or will rely on the parol evidence rule or both. In response, because he is restricted by the formalistic rules of contract and cannot present evidence extrinsic to the written agreement, the borrower will claim that, notwithstanding the terms of the written agreement, the bank has breached the duty of good faith and fair dealing that is implied in every contract. Some empathetic judges will agree with the borrower. Nevertheless, neither approach is satisfactory because, as illustrated below, both ignore the real agreement of the parties, which can only be determined by looking at all of the circumstances surrounding the written agreement, including the written agreement itself.¹⁶²

The two contradictory patterns of analysis just discussed are an example of what "might be expected from the contradictory nature of the modern law's retention and rejection of the classical image in its response to the problems of classical contract law."¹⁶³

Modern contract law . . . embodies two general, contradictory patterns of analysis . . . One pattern is heir to the individualist tradition of the classical image. It proposes a world of autonomous, freedom-seeking beings and a body of contract law which aids them in their search. The other pattern is

157. *Reid*, 821 F2d at 14.

158. *K.M.C.*, 757 F2d at 761.

159. *An Action Checklist for the Lender*, *US Banker* at 22 (May 1986).

160. See notes 130-55 and accompanying text.

161. Macaulay, 11 *Law & Soc'y Rev* at 513 (cited in note 117).

162. See notes 168-202 and accompanying text.

163. *Feinman*, 30 *UCLA L Rev* at 838 (cited in note 103).

its collectivist opposite. This pattern envisions a world of interdependent, cooperating actors and a body of contract law which encourages their cooperation.¹⁶⁴

Gilmore has also noted that the rejection of classical theory proceeds in a "confused and sprawling pattern"¹⁶⁵

Thus, the pattern of analysis using the implied duty of good faith (the second collectivist pattern) is, in large part, an attempt (not necessarily a conscious one) to escape the unjust results caused by the formalism of classical contract law which elevates the written document to an inviolate status.¹⁶⁶ "Each pattern presents only a partially true picture of the social order . . . neither pattern is an adequate basis for contract law and . . . the two together are contradictory."¹⁶⁷ As stated throughout this article, in most of the lender liability cases resorting to the implied duty of good faith, what is really at issue is the meaning the borrower and the lender gave to the words of the written document. Usually, however, the borrower cannot successfully present evidence of all of the circumstances surrounding the agreement due to the existing formalism in contract interpretation. This inability to produce extrinsic evidence produces unjust or illogical results. The reaction to these unjust and illogical results in the case of lender liability cases is to resort to the implied duty of good faith; however, this reaction does not necessarily reflect the expectations of the parties either, and sometimes results in creating duties for the bank to which the bank never agreed. Thus, this approach can also result in unjust and illogical results.

The case of *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting* (the "Bank")¹⁶⁸ will be used to demonstrate the thesis of

164. *Id.*

165. Gilmore, *The Death of Contract* at 74, 98-100 (cited in note 97).

166. This is supported by the fact that England, unlike the United States, does not recognize a general obligation to observe good faith in the performance of a contract. Moreover, in England, unlike the United States, "[w]hen it is argued that a written contract is not conclusive of the obligations of the parties, the court seems simply to balance the arguments for and against imposing an orally derived obligation on a party, rather than treat the writing as conclusive" Atiyah, *Essays On Contract* at 116 (cited in note 110). In other words, because in England parties to a contract are not restricted to the written document to explain their agreement, but rather are able to present evidence of the surrounding circumstances, they do not have to rely upon the equitable principle of good faith to have their reasonable expectations satisfied.

167. Feinman, 30 UCLA L Rev at 839 (cited in note 103).

168. 908 F2d 1351 (7th Cir 1990), rev'g, 104 Bankr 909 (ND Ill 1989), aff'g, 97 Bankr 420 (ND Ill 1989). See also Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 Iowa L Rev 503 (1991) where Patterson critically analyzes Easterbrook's opinion in *Kham*. Although this author agrees with Patterson's charges of

this article. *Kham* was a bankruptcy case in which Kham & Nate's Shoes (the "Debtor") sought to equitably subordinate the Bank's claim based on bad faith termination of a line of credit.¹⁶⁹ The Debtor also brought counterclaims against the Bank alleging breach of contract and breach of the implied duty of good faith.¹⁷⁰ The Debtor operated a retail shoe business in Chicago, Illinois, and the Bank, which was located in Indiana, had first extended credit to the Debtor in July 1981.¹⁷¹ In the fall of 1983, the owners of the Debtor met with a Mr. Donald Cassaday, a senior vice president of the Bank, concerning a loan to ease its cash flow problems.¹⁷² The Bank then issued several unsecured letters of credit in favor of the Debtor's creditors.¹⁷³ Subsequently, in December 1983, the Debtor requested additional credit.¹⁷⁴ At that meeting, Mr. Cassaday enumerated several conditions upon which the Bank would approve a \$300,000 line of credit for working capital to sustain the Debtor's business.¹⁷⁵ The Bank articulated the conditions in a commitment letter sent to the Debtor January 4, 1984. In the letter, the Bank agreed to lend up to \$300,000 in a line of credit as an interim loan on the condition that the Debtor file for relief under Chapter 11 of the Bankruptcy Code and grant the Bank a superpriority lien on essentially all of the Debtor's post-petition assets. The ultimate plan was for a \$1.2 million Small Business Administration guaranteed loan.¹⁷⁶

After the Debtor filed a Chapter 11 petition on January 29, 1984, the bankruptcy court entered an order approving the line of credit and granting the Bank's superpriority lien.¹⁷⁷ On January 23, 1984, the Debtor and Bank signed their loan agreement which opened a \$300,000 line of credit. The agreement provided for cancellation on five days' notice and added "nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time."¹⁷⁸ The Bank advanced approximately \$100,000 to the

formalism against Judge Easterbrook, she disagrees with many of Patterson's other premises. See notes 80-96 and accompanying text.

169. *Kham*, 97 Bankr at 423-24.

170. *Id* at 424.

171. *Id* at 421-22.

172. *Id*.

173. *Id* at 422.

174. *Id*.

175. *Id*.

176. *Id*.

177. *Id*.

178. *Kham*, 908 F2d at 1353.

Debtor. Most of these funds were used to repay credit extended by way of draws on the letters of credit issued by the Bank prepetition. Thus, the Bank acquired a postpetition lien on previously unencumbered assets of the Debtor in order to pay a pre-petition, unsecured obligation.¹⁷⁹

Around February 14, 1984, the Bank's Board of Loan and Investment Committee ("BLIC") directed Cassaday to terminate the line of credit. The reason given was that the BLIC did not like the nature of the credit with the Debtor, did not like the location of the Debtor's business, and did not think that the Bank should be doing business on the south side of Chicago.¹⁸⁰ Although the Bank decided to terminate the line of credit on February 14, 1984, it did not inform the Debtor until two weeks later. In fact, counsel for the Bank attended a creditor's meeting, fully aware of the Bank's decision to terminate, and failed to mention the Bank's decision while affirming to those present that the court had entered the Financing Order approving the Loan and Security Agreement.¹⁸¹

On February 29, 1984, some 30 days from the effective date of the Loan and Security Agreement, the Bank notified the Debtor in writing that it intended to terminate the line of credit with five days' notice. The Bank gave the Debtor no reason for the termination in its written notice. There had been no material change of circumstances between the time the Bank and the Debtor entered into the Loan and Security Agreement and the date on which the Bank terminated the agreement. The Debtor was current in its payment without any difficulty whatsoever.¹⁸² Several weeks later, the Bank's President told one of the Debtor's owners that he did not understand why the Debtor had come to Indiana for financing, that the Bank did not want to do business with the Debtor, and that the Debtor should go back to its own neighborhood to obtain financing.¹⁸³ An alternative reason for the termination was suggested in the President's deposition wherein he indicated that there was an internal conflict at the Bank between Cassaday and the President.¹⁸⁴

After the Bank terminated the line of credit, the Debtor was unable to borrow funds from other sources because its assets were

179. *Kham*, 97 Bankr at 422.

180. *Id.*

181. *Id.* at 423.

182. *Id.*

183. *Id.*

184. *Id.*

encumbered by the Bank's lien. As a result, the Debtor sustained substantial damage to its business. The Debtor had to close stores and cancel plans to open a new one. Subsequently, the Debtor filed an amended plan of reorganization requesting equitable subordination of the Bank's claim alleging bad faith termination of the line of credit.¹⁸⁵ After the bankruptcy court granted the Debtor's request, the Debtor counterclaimed alleging breach of the implied duty of good faith and breach of contract.¹⁸⁶

Relying on Illinois law, the bankruptcy court ruled in favor of the Debtor on its counterclaims and granted the Debtor's motion for summary judgment.¹⁸⁷ Although addressing the claim of breach of good faith separately from the claim of breach of contract, the court's analysis indicated the inessential nature of the good faith claim. The court first addressed the claim of the breach of the duty of good faith. It held that the Bank breached its duty of good faith, reasoning that it:

knew or should have known that its conduct would adversely affect the Debtor's financial condition, that the Bank was aware of the Debtor's condition and of the impact that termination of the line of credit would have upon the Debtor and its creditors, and [because] the Bank's conduct manifests a disregard for the Debtor's reorganization case.¹⁸⁸

Later in the opinion, under Count III—Breach of Contract, the court ruled that Illinois state law imposes on lenders a contractual duty to act in good faith.¹⁸⁹ The court further opined that good faith in the context of termination of a loan agreement means that the termination must be in accord with reasonable expectations of the parties.¹⁹⁰ Then, without any investigation into what the reasonable expectations of the parties were, the court concluded that the Bank's termination was not in good faith "as there existed no valid business reason to terminate the line of credit because the bank was fully secured, received timely payment on its debt, and had the complete cooperation of the Debtor."¹⁹¹

In the Bank's appeal of the bankruptcy court's order for equitable subordination, Judge Easterbrook of the Seventh Circuit Court

185. *Id.* at 423-24.

186. *Id.* at 424.

187. *Id.* at 421, 426. Summary judgment was granted because the issues were the same as those involved in the equitable subordination hearing in which the court concluded that the Bank terminated the line of credit agreement in bad faith.

188. *Id.* at 427.

189. *Id.* at 428.

190. *Id.*

191. *Id.*

of Appeals vacated and remanded the decision of the bankruptcy court, ruling in favor of the Bank.¹⁹² Despite "not doubt[ing] the force of the proverb that the letter killeth, while the spirit giveth life" and acknowledging that "literal implementation of unadorned language may destroy the essence of the venture,"¹⁹³ the court nevertheless proceeded on a road to destruction by relying solely upon the literal interpretation of the unadorned language. The court did recognize the duty of good faith. Its definition of good faith strongly resembled that of Burton.¹⁹⁴ The court asserted: "Good faith is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties."¹⁹⁵ Nevertheless, the court did not examine any conduct that occurred at the time of the drafting, instead basing its reasoning solely on the written words of the agreement:

Firms that have negotiated contracts are entitled to enforce them to the letter . . . without being mulcted for lack of 'good faith' . . . Debtor and Bank signed a contract expressly allowing the Bank to cease making further advances. The \$300,000 was the maximum loan, not a guarantee. The Bank exercised its contractual privilege after loaning Debtor \$75,000; it made a clean break and did not demand improved terms. It had the right to do this for any reason satisfactory to itself.¹⁹⁶

The appellate court criticized the bankruptcy court for adding an overlay of "just cause" to the exercise of contractual privilege because such an overlay would "reduce commercial certainty and breed costly litigation."¹⁹⁷ Furthermore, conceding that the Bank's decision did leave the Debtor "scratching for other sources of credit," the court asserted that the Bank did not create Debtor's need for funds, and it was not contractually obliged to satisfy its customer's desires. "If Kham & Nate's Shoes did not like that op-

192. *Kham*, 908 F2d at 1363. Between the bankruptcy court's and the Seventh Circuit Court's opinions was the opinion of the district court on the equitable subordination issue. *Kham*, 104 Bankr at 909. Although the district court affirmed the order for equitable subordination, it framed the issue in terms of whether the Bank "engaged in fraud, overreaching or spoliation" rather than bad faith because "a claimant's conduct must amount to more than a lack of good faith in order to warrant equitable subordination to his claim." Id at 913. The district court relied on the same facts as the bankruptcy court to conclude that the Bank's actions rose to the higher standard. Id.

193. *Kham*, 908 F2d at 1357.

194. See notes 61-70 and accompanying text.

195. *Kham*, 908 F2d at 1357.

196. Id.

197. Id.

tion, it was entitled to shop around."¹⁹⁸

The reasoning of both courts is flawed. First, neither the bankruptcy court opinion nor the circuit court analysis demonstrates any awareness of the empirical picture of the contract process. The bankruptcy court opinion is representative of the collectivist pattern of analysis that "envision[s] a world of interdependent, cooperating actors and a body of contract law which encompasses their cooperation."¹⁹⁹ According to the bankruptcy court, the Bank should not have done anything that could have adversely affected the Debtor's financial condition. Since the Debtor was being cooperative, as all good contractors should, so should the Bank have been cooperative, whether or not its cooperation would have reflected the agreement. Conversely, the circuit court's reasoning reflects the individualistic tradition of the classical image, a world in which individualism, certainty of meaning, and freedom of contract prevail. According to the circuit court, unless written agreements are enforced according to their express terms, "the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized."²⁰⁰

In addition to a lack of awareness of the empirical nature of the contract process, neither decision relies on any evidence outside the written agreement to determine what the parties' expectations were regarding the termination provision. The issue that should have been addressed is, based on the manifestations of the Bank, what did the Debtor believe would trigger termination by the Bank? The bankruptcy court seems simply to assume that the plain, literal meaning of the written agreement could not possibly reflect the expectations of the borrower, and the circuit court simply assumes that it does. Evidence outside the written agreement should have been considered, particularly specific evidence relating to the negotiations and communications surrounding the termination provision of the Loan and Security Agreement. Although it appears that no specific evidence of such a nature was presented, one should not assume that none was available. This author would suggest that the borrower was dissuaded from even attempting to introduce any oral testimony due to the strict application of the parol evidence rule in Illinois.²⁰¹ Thus, the borrower had to rely

198. *Id.* at 1358.

199. See notes 163-64 and accompanying text.

200. *Kham*, 908 F2d at 1357.

201. See, for example, *Main Bank of Chicago v Baker*, 86 Ill 2d 188, 427 NE2d 94, 98-99 (1981); *Land of Lincoln Sav. and Loan v Michigan Ave. Nat'l Bank of Chicago*, 103 Ill

inappropriately on the equitable principle of good faith. Notwithstanding the lack of any specific evidence, there was some evidence indicating that the Debtor was led to believe that the Bank would not suddenly terminate the loan agreement for nonfinancial reasons. Apparently, the Bank led the Debtor to believe (1) that the ultimate plan was to reorganize the Debtor and (2) that the \$300,000 line of credit was an interim loan until the Debtor obtained a Small Business Administration guaranteed loan.²⁰² It does not seem likely that the Debtor would file for bankruptcy and convert unsecured debt to secured debt if it expected the Bank immediately to terminate the loan agreement without the Debtor having any alternative financing. Evidence relating to the Debtor's expectation on termination was required to effectuate a just result.

In sum, the formalistic rules of contract, which interfere with the determination of the real manifested agreement of the parties, are based on values that supported the classical theory of contract, such as certainty of meaning, individualism, and freedom of contract. The rules do not reflect the realities of present banking practices and thus result in unjust results. The implied duty of good faith is a way to overcome the unjust results; however, relying on the implied duty of good faith is, at best, superfluous and, at worst, unjust. This current approach to deciding the lender liability cases involving interpretation of commercial loan documents fails to provide meaningful guidance. Thus, what is needed is a coherent standard of the discipline of interpretation that reflects current banking practices and determines the meaning intended by the parties by considering all of the circumstances surrounding the agreement.

These principles are not new. They reflect those espoused by Professor Corbin in his treatise published in 1951.²⁰³ Nevertheless, based on the cases which do not reflect commercial reality and do not result in enforcing the true agreement, these principles obviously need further reinforcement. Thus, the next section will discuss a process of interpretation that reflects current business practices and that considers and weighs all of the relevant evidence surrounding an agreement. As explained²⁰⁴ the process is based on the hermeneutic principles of the literary theorist, E.D. Hirsch,

App 3d 1095, 432 NE2d 378, 383 (1982); see also *State Nat'l Bank v Academia, Inc.*, 802 SW2d at 291 (applying Illinois law).

202. See notes 171-79 and accompanying text.

203. Corbin, *Corbin on Contracts* Ch 24 (cited in note 11). See also Corbin, 50 Cornell L Q at 161 (cited in note 11).

204. See notes 8-11 and accompanying text.

whose principles are strikingly similar to Corbin's principles of contract interpretation.²⁰⁵ Because of its emphasis on authorial intent, Hirsch's theory lends itself well to contract interpretation (as opposed to statutory or constitutional interpretation). With contract interpretation, the interpreter does not encounter the problem of determining the "collective" intention of a collegiate body as with statutes and constitutions.²⁰⁶ Moreover, contrary to what some commentators have written about Hirsch's theory, Hirsch does not have specific rules and methods.²⁰⁷ The only methods advocated by Hirsch are those for weighing evidence. Hirsch believes that, "While there is not and cannot be any method or model of correct interpretation, there can be a ruthlessly critical process of validation to which many skills and many hands may contribute."²⁰⁸

III. HIRSCH'S PROCESS AND PRINCIPLES OF INTERPRETATION

According to Hirsch, there are two stages in interpretation. The first is the unmethodical and intuitive stage. It usually results in a mistaken guess. This stage is necessary, maintains Hirsch, for a beginning. The second stage is the more critical stage. At this stage, the methodical activity begins. This is where the conclusion reached by the first stage is tested and criticized against all the relevant knowledge.²⁰⁹

The first intuitive stage is the point at which many courts stop. They determine meaning only from the writing itself. According to Hirsch, this leads to "semantic autonomy" which, in turn, leads to much of our present day theoretical confusion.²¹⁰ Hirsch believes that there is no logical reason to stop here,²¹¹ and explains that semantic autonomy is based on the fallacy that there is public con-

205. Corbin, *Corbin on Contracts* Ch 24 (cited in note 11); Corbin, 50 Cornell L Q at 161 (cited in note 11).

206. See, for example, McIntosh, 35 Okla L Rev at 4 (cited in note 12): "It remains to be asked, however, whether the norm Hirsch suggests would serve any practical value in legal hermeneutics because in law what we invariably encounter when we speak of authorial intention is the collective intention of a collegiate body."

207. See, for example, Sherman, 51 Mod L Rev at 388 (cited in note 12) who states that for Hirsch, "hermeneutics is the body of methodological principles that underlies valid interpretation"; and Phelps and Pitts, 29 SLU L Rev at 354 (cited in note 10) who state that Hirsch sees "hermeneutics as a search for methods of valid interpretation."

208. Hirsch, *Validity in Interpretation* at 206 (cited in note 8).

209. Id at 203-04.

210. Id at 1-5. Similarly, in his article criticizing the parol evidence rule, Corbin refers to this as hitting the "semantic stone wall." Corbin, 50 Cornell L Q at 187 (cited in note 11).

211. Hirsch, *Validity in Interpretation* at 2 (cited in note 8).

sensus as to meaning.²¹² This is not to say that an author can attach any meaning she wants to a word. Hirsch believes that norms of language exert a powerful influence and impose an unavoidable limitation on both author and interpreter.²¹³ Nevertheless, the norms of language are not uniform or stable but vary with the particular sort of utterance that is to be interpreted."²¹⁴

Because the norms or "ground rules" of language vary greatly, it is not impossible that one person can be playing by a different set of rules than the other. Therefore, Hirsch postulates that the decisive element in interpretation is *shareability*. Accordingly, he maintains that what we are searching for in interpretation is shared verbal meaning, that is, whatever someone has willed to convey by a particular sequence of linguistic signs which can be conveyed (shared) by means of these linguistic signs.²¹⁵ By referring to someone's "will to convey," Hirsch is not implying that meaning is determined only by what is in someone's mind. He does not require a "meeting of the minds" as implied by one commentator.²¹⁶ Hirsch asserts that "[i]t betrays a totally inadequate conception of verbal meaning to equate it with what the author has in mind."²¹⁷

One cannot convey a particular meaning to another if the other person is not familiar with a particular meaning. Thus, understanding can only occur if the interpreter proceeds under the same system of expectations as the author. Transference of meaning from author to interpreter can be achieved only if the author is familiar with typical past usages and experiences common to him-

212. Id at 13.

213. Id at 27.

214. Id at 30-31. Corbin also criticizes this approach to interpretation, asserting that it is erroneous to assume uniformity and certainty in language. Corbin, 50 Cornell L Q at 161 (cited in note 11).

215. Hirsch, *Validity in Interpretation* at 31 (cited in note 8).

216. See McIntosh, 35 Okla L Rev at 36-37 (cited in note 12).

217. Hirsch, *Validity in Interpretation* at 31 (cited in note 8). Corbin also recognizes the varied ground rules of language: "In interpreting written words, a party may always prove that they were to him a foreign tongue, that they are the words of a professor of philosophy and he is only a peasant, that they are the language of a lawyer and he is only a professor of philosophy." Corbin, *Corbin on Contracts* § 543 at 151 (cited in note 11).

Corbin also acknowledges the importance of the concept of shareability of meaning. For example, he asserts that "it is not the meaning of a 'reasonably intelligent man' or of a 'normal user of English' that the court is trying to discover and make effective . . . The court will give legal effect to the words of a contract in accordance with the meaning actually given to them by one of the parties, if the other knew or had reason to know that he did so." Id § 543 at 140. Thus, for Corbin, the meaning of the words of the contract is the meaning *shared* by the two parties. Id.

self and his interpreter. By virtue of shared past experiences, the type of meaning he expects to convey will be the type of meaning his interpreter will also be led to expect. This is not to say that the author and interpreter must have had extensive shared past experiences. All that need occur is that the interpreter must in some way learn the different meanings of words. Or, as Hirsch explains it, the interpreter must learn the characteristics of a certain type, for characteristics are not usually "syncategorematic" or absolutely necessary comeanings.²¹⁸ Nevertheless, it is sufficient merely to give the interpreter a decisive clue as to the particular meaning that is intended.²¹⁹

Neither Hirsch nor Corbin claims that absolute certainty of the shared meaning can be achieved. Claims need to be moderated to reflect the peculiarities and difficulties attending the interpretive enterprise.²²⁰ Therefore, both speak in terms of probabilities.²²¹ Hirsch chides us, however, that notwithstanding lack of certainty, we should not reach the "overly hasty conclusion that the author's intended meaning is inaccessible and is therefore a useless object of interpretation."²²² We can reach and agree on the most probable conclusions in the light of what is known. But this requires someone performing the arduous task of adjudicating the issue in the light of all that is known.²²³ It requires a consideration of all of the known relevant data, both external and internal. Internal evidence based only upon the written text is insufficient and unreliable.²²⁴ The main task is to discover as much external evidence as possible. Again, with respect to this task, Corbin and Hirsch are in agreement. Corbin admits that discovering external evidence "may indeed be a difficult task."²²⁵ Similarly, Hirsch states that such discovery requires "severe discipline" and "an irritable reaching after fact and reason."²²⁶

When considering external evidence, both assert that evidence must be accepted as relevant whenever it helps to show any ex-

218. Hirsch, *Validity in Interpretation* at 66-7 (cited in note 8).

219. *Id.*

220. *Id.* at 164.

221. Corbin, *Corbin on Contracts* § 535 at 15-16, § 543 at 150 (cited in note 11); Hirsch, *Validity in Interpretation* at ix, 207 (cited in note 8).

222. Hirsch, *Validity in Interpretation* at 17 (cited in note 8).

223. *Id.* at 171.

224. *Id.* at 193.

225. Corbin, *Corbin on Contracts* § 543 at 140 (cited in note 11).

226. Hirsch, *Validity in Interpretation* at ix (cited in note 8).

isting usage of the specific word or words being interpreted.²²⁷ For example, usage can include customs and usages of other people in similar circumstances and usages of words as reported in respectable dictionaries.²²⁸ Also, evidence is relevant whenever it increases the number of instances in which the word has been used in a particular way being advocated by one of the parties.²²⁹ Obviously, general evidence of interpretations which occur more frequently is weightier than general evidence of interpretations which occur less frequently. Finally, detailed, specific evidence relating to the author or the text at issue is always more weighty than any general evidence.²³⁰ The chief concern, then, is to ferret out as much external, detailed, specific information as possible about the particular text and transaction at issue.²³¹

Application of these principles is illustrated by Hirsch's process of determining the meaning of the word "wit" as used by an eighteenth century writer:

We infer that an eighteenth-century writer using the word "wit" probably means something general like "intelligent competence" rather than just "clever repartee," because the former is what other eighteenth-century writers mean by "wit" more often than not. . . . If, for example, we had fifty instances of the word "wit" in the eighteenth century and found that thirty-five of them used the word in its broad sense, then we would, *in the absence of other, narrowing data*, be obliged to guess that the instance under scrutiny also conveys that broad sense. But while our judgment, on the basis of the known data, would be valid, we could place very little reliance on it and would undoubtedly seek to make our guess more reliable. If, on the other hand, all known instances of "wit" in the eighteenth century conveyed the broad sense, then we could place far more reliance on our guess, since its probability of being correct would have greatly increased. . . .

[For more reliability], [t]he kind of evidence we need is information concerning those instances which are more and more like the instance about which we are guessing. If, for example, we ascertain that our text is by a man named Rivers, and if we discover that Rivers apparently always uses "wit" to mean "clever repartee," then, on this further evidence, we would be

227. Corbin, *Corbin on Contracts* 140, 150 (cited in note 11); Hirsch, *Validity in Interpretation* at 184 (cited in note 8).

228. Corbin, 50 Cornell L Q at 190 (cited in note 11).

229. Corbin, *Corbin on Contracts* at 150 (cited in note 11); Hirsch, *Validity in Interpretation* at 184 (cited in note 8).

230. Hirsch, *Validity in Interpretation* at 185 (cited in note 8).

231. *Id.* at 186, 188. See also Corbin, 50 Cornell L Q at 188-89 (cited in note 11). "First and foremost, extrinsic evidence is always necessary in the interpretation of a written instrument." *Id.*

right to guess that the present use also means "clever repartee" even though this guess is in conflict with the guess made on the basis of all known uses of the word in the eighteenth century.²³²

If we apply these principles to resolve an issue of meaning that seems to arise frequently with commercial loan documents, such as the meaning of "demand" in a demand note, we would first accept any evidence of usages of the word in similar circumstances, both by banks in general and by the specific bank who is a party to the present litigation. Consequently, we would accept the testimony of the bank president who testified that "based on his knowledge of banking practices . . . a bank could not simply terminate [an agreement with a demand provision] capriciously," and that "the absence of a time term in [a demand] note indicated the likelihood that the schedule for repayment of the principal was governed by a verbal agreement. . . ."²³³ Similarly relevant would be the testimony of the bank president who testified that "it was not a policy of [his bank] to terminate financing without notice [if a loan was well secured]."²³⁴

In the absence of other narrowing data, if, in the majority of similar situations, "demand" was interpreted as meaning "demand only after reasonable notice if a loan was well secured," then that would be the most valid, objective interpretation to give the word, *but only if that was a meaning of which the borrower was aware and a meaning that could be said to have been conveyed to the borrower by the bank*. When we are only relying on general evidence of this type, the concept of shareability is important. The meaning must be one that was shared by the parties; it cannot be a special meaning known to only one of the parties. The concept of shareability thus requires consideration of the special mentality, experience and education of the parties, particularly the borrower, to determine if the borrower was able to understand the special meaning being given to the word "demand." If the borrower was not aware of the policy of the bank to give notice before demanding payment, and that meaning was not otherwise conveyed to (shared with) the borrower, then he cannot be said to have a reasonable expectation of receiving notice before demand under a demand provision.

Most importantly, for more reliable interpretations, we would

232. Hirsch, *Validity in Interpretation* at 184-85 (cited in note 8)(emphasis in original).

233. *Reid*, 821 F2d at 14.

234. *K.M.C.*, 757 F2d at 761.

accept evidence of the antecedent negotiations and communications between the parties as to the meaning the parties gave to the word. In addition, we would accept evidence of the conduct of the parties subsequent to signing the agreement that related to the word at issue. This evidence would, of course, outweigh any of the general evidence described above since it would tell us specifically what meaning the parties themselves gave to the word. There is, inevitably, the risk of self-serving testimony. Nevertheless, there is always such a risk in any trial, and the job of the fact finder is to listen to all of the evidence and determine who is telling the truth and who is not. Obviously, the more uncommon the definition being advocated, the harder the advocate must work to convince the fact finder that her definition is the most valid, objective definition based on all of the evidence.

The principles advocated above are illustrated by *Siegner v Interstate Product Credit Ass'n*²³⁵ ("Interstate"), one of the few cases in which a court considered all of the relevant evidence, after taking a rather circuitous route.²³⁶

In *Siegner*, the communications and negotiations between Mr. Siegner and Mr. Fewel (the "Borrowers") and Interstate began in the late 1970's when Ron Jinings, a loan officer of Interstate, visited the Borrowers to persuade them to start doing business with his employer. Jinings told them that his employer was the premier agricultural lender in the region; that it understood the ups and downs of the cattle market; and that it stayed with its borrowers for the "long haul."²³⁷ The Borrowers initially rebuffed Jinings' efforts. Jinings, however, was not a quitter; he continued to visit them every few months. Finally, in 1980, he persuaded them to purchase a nearby cattle ranch - the Coleman Ranch.²³⁸ Aware that it would take at least fifteen years to make an appreciable reduction in the indebtedness created by this purchase, Jinings advised the Borrowers that Interstate could, of course, be counted on to not only finance the down payment, but also to advance funds in the future to pay for the annual payments for the Coleman Ranch

235. 190 Or App 417, 820 P2d 20 (1991).

236. *Siegner*, 820 P2d at 25-28. First the court had to find a way around the road block set up by the parol evidence rule. Thus, it initially engaged in a rather lengthy, involved explanation of the rule before it could admit all of the relevant evidence surrounding the making of the agreement, including the communications and negotiations that occurred prior to signing the agreement. *Id.*

237. *Id.* at 23.

238. *Id.* at 22-23.

and Wrench Ranch, a ranch presently-owned by the Borrowers but with an unpaid balance.²³⁹ Also during their discussions, in addition to telling the Borrowers that Interstate would not interfere with the Borrowers' management, Jinings led the Borrowers to believe that Interstate would provide financing to begin a yearling operation²⁴⁰ and would provide financing to replace culled cows so the ranch could remain stocked to capacity.²⁴¹

Relying on Jinings' assurances and with Jinings' knowledge, the Borrowers executed an agreement to purchase the ranch with annual payments extending over fifteen years. After signing the sales agreement for the ranch, the Borrowers, without any counsel, met with Jinings to execute the loan documents.²⁴² Notwithstanding Jinings' assurances of noninterference with management and his awareness of the need for long-term financing, the loan was structured for only one year and contained a provision which permitted Interstate to require the Borrowers to inject cash if the loan margin fell below acceptable levels.²⁴³ Not unexpectedly, the Borrowers were surprised, since Jinings' statements had indicated that the agreement would be otherwise. Jinings told the Borrowers not to worry about the one year structure and the requirement of cash injection. Both were mere formalities. Interstate would, without significantly changing the major terms of the loan, roll over the balance from year to year until the loan was paid in full. On these assurances, the Borrowers signed the documents.²⁴⁴

Despite these comforting words of assurance, each time the loan came up for renewal, Interstate added some new condition or refused to extend financing to the level Jinings had promised. First, it refused to loan sufficient funds to enable the Borrowers to restock culled cows fully and to begin a yearling operation. Second, it required one of the Borrowers to give a second mortgage on one of his other ranches. Next, it declined to advance funds for the annual payment of the Coleman Ranch. Eventually, it required liquidation of the Coleman Ranch. Finally, in 1987, when Interstate began to demand liquidation of cattle on Wrench Ranch, the

239. *Id.* at 22.

240. *Id.* at 23. A yearling operation entails keeping calves for an additional season and selling them as yearlings, instead of selling calves immediately after birth.

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.*

Borrowers refused.²⁴⁵

Subsequently, in September 1987, Interstate sent a letter threatening foreclosure if the Borrowers did not submit an operation plan acceptable to Interstate.²⁴⁶ Prior to this letter, the Borrowers had submitted several plans, all of which Interstate rejected. Soon after receipt of the letter, the Borrowers brought an action against Interstate alleging the two all-time favorite claims - breach of contract and breach of the implied duty of good faith.²⁴⁷ The court implicitly recognized that the latter claim was inessential, and that the only claim was whether Interstate breached its agreement, including the promises manifested by Jinings to the Borrowers prior to signing the loan documents.²⁴⁸ Since Interstate was not disputing the making or the content of the oral assurances as presented by the Borrowers, the court stated that the major underlying issue was "whether the evidence surrounding the parties' agreement . . . should have been excluded because of the parol evidence rule."²⁴⁹

As stated earlier, the court felt compelled to engage in a long, involved explanation and interpretation of the rule in order to admit the evidence.²⁵⁰ Despite the presence of a merger clause, which the court decided was inconclusive, the court agreed with the jury that the documents did not represent the entire agreement.²⁵¹ The court reasoned that the parties could not have intended a one year loan because the Borrowers' cash flow and budget forms, which were part of the loan agreement, clearly showed that sufficient income would not be generated to pay the loans on their maturity dates.²⁵² Additionally, the court relied upon the circumstances surrounding the extensive negotiations and execution of the written documents, which showed that both the Borrowers and Interstate knew at the time the loan documents were executed that it was impossible for the Borrowers to pay the loan in one year. Therefore, it would have been highly unlikely for either to have agreed to a loan that would not be paid when due.²⁵³ Jinings' oral assurances of long-term financing were additional factors on which the

245. *Id.* at 24.

246. *Id.* at 25.

247. *Id.* at 22, 25.

248. *Id.* at 25.

249. *Id.*

250. *Id.* at 25-29.

251. *Id.* at 26.

252. *Id.* at 26-27.

253. *Id.* at 27.

court based its decision.²⁵⁴ Finally, the court considered Interstate's lending policies and the nature and volatility of the cattle business to determine if the oral agreement to renew the loan annually over the long term was inconsistent with the writings providing for one year loans.²⁵⁵ The court concluded that the oral agreement was not inconsistent since the amounts required to stock and operate the combined ranches varied from year to year, and were to be worked out by the parties when the Borrowers submitted their proposed budget for the ensuing year.²⁵⁶ The court then affirmed the lower court's decision to permit the jury to consider the oral evidence for the purpose of establishing the oral agreement.²⁵⁷

Nonetheless, Interstate did not stop here. It then relied on another common route to escape liability; the rule requiring definiteness and certainty of terms.²⁵⁸ Interstate contended that even if the parol evidence was admissible, the alleged oral agreement was indefinite as to the amount of the loan, the interest rate, the repayment schedule and the term of the loan.²⁵⁹ The court held, however, that there was no requirement that a contract be explicit or precise, so long as the parties had agreed to a method for determining the performance agreed to by the parties.²⁶⁰ According to the court, the parties had so agreed, since "[t]here was evidence that defendant made assurances that it would renew the annual loan over a 15-year period to permit plaintiffs to complete their purchase of the Coleman Ranch [and] that defendant agreed to lend an amount sufficient to operate both ranches annually, including funds to make the payment due on the real estate, to pay for operations and to keep the ranch properly culled and fully stocked with cattle."²⁶¹

Finally, the court summarily dispensed with the good faith issue, since it was obviously unnecessary after the court decided that Interstate breached its agreement with the Borrowers. In essence, the court concluded that because Interstate had breached its contractual duties to the Borrowers, it also breached the implied duty of

254. *Id.* at 28.

255. *Id.* at 27.

256. *Id.*

257. *Id.* at 28.

258. *Id.* at 28-29.

259. *Id.*

260. *Id.* at 29.

261. *Id.*

good faith.²⁶²

Basically, the court followed Hirsch's principles. It started with the first unmethodical and intuitive stage by giving some consideration to the plain meaning of the written terms, particularly the one year term of the promissory note and the merger clause. It did not stop here, however, as many courts do.²⁶³ Instead, it went on to the second methodical stage, testing the plain meaning against all of the relevant evidence surrounding the making of the agreement. The court accepted both (1) detailed specific evidence of the particular transaction at issue, such as cash flow and budget forms, and (2) general evidence, such as Interstate's lending policies and the cattle business.²⁶⁴ Finally, it determined, based primarily on the "past shared experiences" of the Borrowers and Jinings, (specifically their antecedent negotiations and communications,) that it was not unreasonable for the Borrowers to interpret the one year agreement to mean that it would be renewed without any significant change in terms other than the amount to be loaned based upon the Borrowers' needs.²⁶⁵ Furthermore, the court concluded that it was not unreasonable for the Borrowers to expect that the amount to be loaned would include funds for a yearling operation, replacement cattle and annual payments for the Coleman Ranch and Wrench Ranch.²⁶⁶ Additionally, the court, in keeping with the principles of Hirsch, acknowledged that in its interpretive task, it was not dealing with certainty, but only with probabilities. It therefore postulated its conclusion in terms of probabilities: "It would have been highly unlikely for either plaintiffs or defendant to have agreed to a loan for only one year that would not be paid when due."²⁶⁷

A comparison of the analysis used above, which illustrates Hirsch's principles, with the formalistic, individualistic analysis used by the Seventh Circuit in *Kham*²⁶⁸ shows that the Hirsch approach is preferable because it leads to more validity, intellectual respectability and, most importantly, fairness. It does so because it leads to the agreement most likely intended by the parties by considering and weighing all of the relevant evidence. Furthermore,

262. Id at 31-32.

263. See, for example, *Kham*, 908 F2d at 1357; and *Shiplet*, 762 P2d at 245.

264. *Siegner*, 820 P2d at 26-27.

265. Id at 27.

266. Id at 29.

267. Id at 27.

268. See notes 168-98 and accompanying text.

when the court's analysis in *Siegner* is compared to the collectivistic analysis used by the Sixth Circuit in *K.M.C.*,²⁶⁹ it is evident that here as well, Hirsch's approach is preferable. The *Siegner* court searches for the agreement of the parties based upon all of the relevant evidence, not some agreement fabricated by the fact finder as the most commercially reasonable. Additionally, the Hirsch approach is the only one that acknowledges present day business practices of commercial lenders, who engage in extrinsic conduct that affects the borrowers' interpretation of the meaning of the written agreement. Finally, it is the only approach that fulfills one of the chief purposes of contract law - securing the realization of expectations reasonably induced by the outward manifestations of the parties.

CONCLUSION

The ubiquitous implied duty of good faith is a doctrine that adds nothing but confusion and, sometimes, injustice when relied upon in cases in which a borrower is suing its lender for what is in reality a breach of contract claim, where the underlying issue is one of interpretation. Nevertheless, because most courts do not look beyond the four corners of the written document in cases involving financial institutions, borrowers have had to rely upon the equitable principle of the implied duty of good faith to protect their rights. More specifically, because of strict adherence to the formalistic rules of contract relating to interpretation, such as the plain meaning rule, the parol evidence rule, and the definiteness of terms rule, borrowers have been prevented from presenting evidence of loan officers' conduct to prove the meanings given to certain written terms in loan documents. As a result, lenders have sometimes been permitted to escape contractual liability. Focus on the duty of good faith, however, has obfuscated the real issue, which is, what meaning did the parties give to the terms in the written agreement? In addition, imposition of a duty of good faith has sometimes unjustly created duties to which the banks never agreed.

The resolution of the problem is explicit recognition that the issue is one of interpretation, not of good faith. Then, courts must begin to apply a coherent standard of interpretation that reflects current banking practices and determines the intent of the parties at the time the agreement was made. In order to do this, courts

269. See notes 26-42 and accompanying text.

must consider all of the circumstances surrounding the making of the agreement. The standard suggested by this article is based upon the principles of E.D. Hirsch. Hirsch believes that one must base interpretation on all of the relevant evidence surrounding the text, especially detailed, specific evidence extrinsic to the text. As applied to the interpretation of commercial loan documents, this means that courts must begin to move beyond the four corners of written agreements and consider the circumstances surrounding the making of the agreement between the parties. This includes the negotiations and communications between the parties; general bank practices in similar situations; and the special mentality, experience and education of the parties. As a result, the agreement that will be imposed upon the parties will be the agreement that was intended by the parties based on their outward manifestations and their "shared experiences." Unjust and illogical results can then more often be prevented, and banks can be held accountable for their not uncommon "comforting words of assurance."